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IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO,
Petitioner,

v.

CONOCO, INC., AND INTEL CORPORATION,
Respondents.

Petition for a Writ of Certiorari to the Supreme Court of the State of New Mexico

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does a state corporate income tax violate the Foreign Commerce Clause where the taxing system uses formulary apportionment principles to exclude dividend income earned in foreign commerce while using federal arms-length accounting principles to exclude dividend income earned in domestic commerce?

2. May the states include foreign-source dividends in their apportioned tax bases subsequent to this Court's decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), where the states include the factors of a taxpayer's foreign dividend payors in the apportionment formula?

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PETITION FOR A WRIT OF CERTIORARI

The New Mexico Taxation and Revenue Department respectfully petitions for a writ of certiorari to the New Mexico Supreme Court.

OPINIONS BELOW

The opinion of the New Mexico Supreme Court (Appendix A at App. 1-App. 21) is reported at __N.M.__, 931 P.2d 730 (1996). The opinion of the New Mexico Court of Appeals in *Conoco, Inc. v. Taxation and Revenue*

Department (Appendix B at App. 22-App. 57) is reported at __N.M.__, 931 P.2d 739 (Ct. App. 1995). The opinion of the New Mexico Court of Appeals in *Intel Corporation v. Taxation and Revenue Department* (Appendix C at App. 58-App. 67) is currently unreported. The Decisions and Orders of the hearing officer of the Taxation and Revenue Department in both cases (Appendix D at App. 68-App. 123, and Appendix E at App. 124-App. 168, respectively) are unreported.

JURISDICTION

The jurisdiction of this Court rests on 28 U.S.C. § 1257(a). The judgment of the New Mexico Supreme Court was entered on November 26, 1996. The New Mexico Supreme Court denied the Taxation and Revenue Department's Motion for Rehearing on January 23, 1997. Appendix F at App. 169-App. 170.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const., art. I, § 8, cl. 3, provides: "The Congress shall have Power...[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

Relevant portions of the New Mexico statutes defining base and net income and the New Mexico codification of the Uniform Division of Income for Tax Purposes Act ("UDITPA") are set forth in Appendix I at App. 174-App. 177. Taxation and Revenue Department Regulation UDI 19:10 (1994) is set forth in Appendix J at App. 178-App. 180.

STATEMENT OF THE CASE

This petition results from the astonishing failure of the New Mexico Supreme Court to apply the most basic concepts of the unitary business principle of income taxation to evaluate the state's resolution of the facial discrimination challenge presented in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance,* 505 U.S. 71 (1992). If allowed to stand, the New Mexico Supreme Court's decision will cause considerable confusion with respect to the meaning of *Kraft*, as well as the remedies available to states under *McKesson Corporation v. Division of Alcoholic Bev. and Tobacco,* 496 U.S. 18 (1990) when a statute is declared unconstitutional.

Virtually all states which impose a corporate income tax use a system of formulary apportionment to determine how much of a multi-jurisdictional taxpayer's income is earned within the state. 1 *W. Raabe & K. Boucher, Multistate Corporate Tax Guide,* pp. 377-382 (Panel, 1996). Formulary apportionment eliminates the intentional and unintentional shifts of value among jurisdictions by assuming that income is earned equally throughout all components of a business enterprise, and that in-state profits can accordingly be estimated by measuring a taxpayer's relative business presence within the state. The unitary business principle is closely related: it applies formulary apportionment principles to the combined incomes of commonly-owned and interdependent enterprises, eschewing reliance on "arms-length" or "geographic" accounting methods to determine the profitability of the separate corporations which make up the business enterprise. *See, e.g., Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,* 266 U.S. 271 (1924). About half

the states require groups of unitary corporations to file returns on a "unitary combined" basis, and about half the states, including New Mexico, require or allow corporate taxpayers to apportion their multijurisdictional income on a separate entity basis. 1 *Multistate Corporate Tax Guide, pp. 532-537.* Virtually all states also use federal taxable income as a starting point to measure the profits of corporate taxpayers which are then subject to apportionment. 1 *J. Hellerstein, State Taxation, Corporate Income and Franchise Taxes,* § 7.2 (1st. ed. 1983).

In *Kraft*, this Court held that separate entity reporting systems which "piggy-back" on federal taxable income standards facially discriminate against foreign commerce because the dividends received from a taxpayer's domestic subsidiaries are generally subject to a deduction pursuant to the Internal Revenue Code ("IRC"), while dividends received from foreign subsidiaries are not. Following *Kraft*, the respondents sought tax refunds in New Mexico measured by the tax effect of excluding their unitary "foreign-source" dividends from the income tax base. The taxpayers' refund claims were based on principles of "geographic" or "arms-length" accounting, which assumes that dividends reported by unitary foreign subsidiaries were generated entirely by overseas operations, with no possibility of income shifting or synergy between related businesses. Rather than excluding foreign-source dividends from the tax base, the state modified its apportionment formula by adding the "factors" of the taxpayers' unitary foreign subsidiaries to the denominator (or "everywhere" portion) of the apportionment formula. This

modification—known as the "Detroit formula"[1] of factor relief—is based upon the unitary business principles underlying the world-wide combined reporting method upheld by this Court in *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159 (1983), and more recently, in *Barclays Bank PLC v. Franchise Tax Board,* 512 U.S. 298 (1994). The state chose the Detroit formula's application of formulary apportionment principles over the taxpayer's geographic accounting model because formulary apportionment has been recognized as the best available method to "capture the many subtle and largely unquantifiable transfers of value" among separate members of an integrated business enterprise. *Container,* 463 U.S. at 164-5.

The New Mexico Supreme Court held below that while factor representation of foreign dividend payors might eliminate disparate taxation of foreign source income generally, it could not be used as a remedy for *these* taxpayers since their tax liabilities with factor representation were still higher than they would have been with foreign dividend exclusion, 931 P.2d at 735. The decision simply ignored the theory of formulary apportionment and the unitary business principle, which recognizes that profits reported by an out of state unitary business may arise in part from activity carried on within the state by the taxpayer.

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[1]The "Detroit formula" derives its name from a 1978 agreement between the City of Detroit and Ford Motor Co. on the taxation of dividend income, in which the city agreed to include a percentage of the taxpayer's foreign-subsidiary factors in the apportionment formula. 1 *State Taxation, Corporate Income and Franchise Taxes,* pp. 557-8 (1983).

By failing to understand the role of formulary apportionment in excluding extra-territorial income from taxation, the court below missed an opportunity to bring a principled resolution to the decades-long controversy over state taxation of foreign-source dividend income. *See, e.g., Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425 (1980); *F.W. Woolworth & Co. v. Taxation and Revenue Department,* 458 U.S. 354 (1982); *Tambrands v. State Tax Assessor,* 595 A.2d 1039 (Me. 1991); *NCR Corporation v. Comptroller,* 313 Md. 118, 544 A.2d 764 (1988). The state's response to the *Kraft* decision recognizes that factor representation is the appropriate answer to the long-standing claims of taxpayers that inclusion of foreign-source dividends in the tax base overstates domestic income by ignoring the income-producing contributions of foreign subsidiaries. At the same time, by retaining foreign-source dividends in the tax base, state revenues are protected from deliberate or unintended profit-shifting to foreign subsidiaries. By ignoring the role of factor representation as a means of appropriately excluding extra-territorial income from taxation, the court below has taken a significant step backwards in the resolution of this important issue.

The lower court also refused to acknowledge this Court's decision in *McKesson Corporation v. Division of Alcoholic Bev. and Tobacco,* 496 U.S. 18 (1990), which holds that when a statute has been declared unconstitutional, the states retain a wide degree of latitude to adopt and apply a remedy which in hindsight creates a non-discriminatory *system.* Instead, the lower court held that any remedy to facial discrimination must be measured by reference to results under the former system, as applied to individual taxpayers. If followed by other states, the lower court's misreading of

McKesson would severely limit state options when a statutory system has been challenged on constitutional grounds.

1. MATERIAL FACTS

Conoco, Inc. ("Conoco") is an integrated oil and gas company engaged world-wide in locating, producing, refining and marketing oil and gas products. Conoco is a subsidiary of E.I. du Pont de Nemours and Company, a Delaware corporation. Conoco conducts its business directly and through 85 U.S. subsidiaries and 107 subsidiaries incorporated overseas. Most of Conoco's crude oil stock is produced by foreign subsidiaries and refined and marketed in the United States by Conoco and its domestic subsidiaries. Conoco and its foreign and domestic subsidiaries constitute a unitary business enterprise. During the years at issue in this case, 1988 through 1991, Conoco operated approximately 1,200 oil and gas wells in New Mexico and had an interest in another 6,200 wells. In addition, Conoco's New Mexico activities included marketing gasoline and operating two natural gas processing plants.

Intel Corporation is the world's largest manufacturer of integrated computer circuits. Intel operates a large factory in Rio Rancho, New Mexico, where circuits are etched onto silicon wafers. These wafers, each of which contains several dozen circuits, are then shipped to Malaysia or the Philippines where an Intel subsidiary cuts the wafers and prepares the individual circuits for use in a computer. Intel's products may be transferred up to ten times among subsidiaries before the final products are sold to an unrelated third party. Intel operates a unitary worldwide manufacturing and retailing business directly and through 23

domestic subsidiaries and 47 foreign subsidiaries, including sales corporations in tax haven countries as noted below.

New Mexico's formulary apportionment system, NMSA 1978 Comp., Sections 7-4-1 through 7-4-20 (1988 Repl. Pamp.), uses a three-factor formula consisting of property, payroll and sales to determine a taxpayer's relative business presence in the state.[2] The resulting apportionment percentage is then applied against the taxpayer's net income to determine the percentage of that income earned in the state and thus subject to tax. Conoco's average "New Mexico percentage" of its business in the state from 1988 through 1991 was 3.04%. With the inclusion of Conoco's foreign subsidiaries' factors to the denominator of the apportionment formula under the "Detroit formula" of factor relief, the percentage of Conoco's business subject to tax by the state was reduced to an average of 2.82%. Intel's average "New Mexico percentage" from 1988 to 1991 was 8.29%. Under the Detroit formula, the percentage of Intel's business subject to tax by the state was reduced to an average of 7.69%.

During the tax years at issue, both taxpayers received a significant portion of their foreign-source income in the form of "deemed dividends" under Subpart F of the Internal Revenue Code ("IRC"), §§ 951-964. This is income reported by captive insurance companies, sales companies and holding companies ("controlled foreign corporations", or

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[2]The formula is codified as the Uniform Division of Income for Tax Purposes Act ("UDITPA"), and is "something of a benchmark by which other apportionment formulas are judged." *Container*, 463 U.S. at 170.

"CFC's"), often incorporated under the laws of "tax haven" countries. Congress passed Subpart F in 1962 out of concern that taxpayers were sheltering U.S. earnings in foreign corporations through manipulation of transfer prices. 1 *Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders,* ¶ 17.32 (4th. ed. 1979). Under Subpart F, the income of certain controlled foreign corporations is deemed to have been earned by the domestic parent corporation in the year it is realized on the books of the CFC. (When and if the income is repatriated in the form of an actual dividend, that dividend income is subject to an exclusion under the IRC since the payor's earnings have already been subject to federal tax.) In the cases below, the state treated "deemed dividends" from CFC's as true foreign dividends for purposes of providing factor relief. Because many of these CFC's exist largely on paper, adding the property, payroll and sales of these entities to the apportionment formula did not significantly reduce the "New Mexico percentage" of the taxpayers' business attributable to activities in the state. That result does not indicate a failing of the formulary apportionment system; to the contrary, it indicates that the arms-length attribution of profits to these foreign subsidiaries was overstated in relation to the contributions of the taxpayers' domestic operations. Approximately 34% of Conoco's foreign-source income for the tax years at issue was received in the form of Subpart F income. Intel received over $205 million in the form of Subpart F income during the tax years at issue, 47% of its total foreign-source dividend income.

2. THE DECISIONS BELOW

The *Conoco* and *Intel* cases were heard separately before the administrative hearing officer for the Taxation and Revenue Department in 1994. In both decisions, the hearing officer held that the state's modification of the formulary apportionment system removed the discrimination against foreign commerce identified in *Kraft*. The basis of the hearing officer's conclusion was that the foreign commerce which generated the dividends was treated equally to domestic commerce, that is, where the income of some portion of the unitary business was included in the apportioned income base, so were the factors of the entity which generated that income. Where income was excluded from the income base, e.g., domestic dividends or foreign earnings not repatriated in the form of dividends, no factors were included. The hearing officer also found, based on the testimony of two economists, that it was appropriate to apply the state's three-factor apportionment formula to these taxpayers' domestic and foreign businesses since: (a) the taxpayers were both highly unitary; and (b) there was no economic advantage to doing business overseas which inherently made overseas' operations more profitable. *Accord, Container,* 431 U.S. at 131-132. Finally, the hearing officer found that the Detroit formula worked: in comparing two equally-situated subsidiaries paying identical dividends, one domestic and one foreign, including the factors of the foreign subsidiary equaled the tax effect of excluding the domestic subsidiary's factors and dividends. This is the essence of a facially non-discriminatory system.

The New Mexico Court of Appeals, in a 2-1 decision, upheld the decision of the hearing officer in the *Conoco* case.

Conoco, Inc. v. Taxation and Revenue Department, 931 P.2d 739 (Ct. App. 1995) (Appendix B). The court concluded that by ensuring that New Mexico did not tax income generated beyond its borders, fair apportionment did indeed operate to remove the unequal burden on foreign commerce identified in *Kraft*. 931 P.2d at 750. In an unpublished decision dated June. 30, 1995, a different panel affirmed the hearing officer's decision in the *Intel* case on *stare decisis* grounds. (Appendix C). Judge Donnelly dissented in both cases.

The New Mexico Supreme Court reversed the court of appeals. *Conoco, Inc. and Intel Corp. v. Taxation and Revenue Department,* 931 P.2d 730 (1996) (Appendix A). The court held that factor representation didn't cure the discrimination identified in *Kraft* because the results under formulary apportionment didn't equal "arms-length" dividend exclusion. In its originally-issued opinion (Appendix K), the court recognized that this difference was caused by the fact that the taxpayers' foreign subsidiaries reported more income generated by fewer "factors", i.e., the foreign subsidiaries appeared to be more "efficient" than the taxpayers' domestic operations. The Department filed a motion for rehearing, pointing out that the court's reasoning ran completely contrary to the unitary business principle—that is, by definition profits are generated equally among all members of a unitary enterprise because the enterprise operates as a whole. Thus, a holding company incorporated under the laws of Barbados for the purpose of reporting sales is not more "efficient" or "profitable" than the domestic parent which made the product being sold, regardless of how much profit is attributed to the holding company through "arms-length" accounting. In response to the state's motion, the court withdrew its reasoning, but retained the conclusion that

the Detroit formula failed to cure the discrimination identified in *Kraft*.

REASONS FOR GRANTING THE WRIT

As the concept of a "global economy" moves from political rhetoric to economic reality, the states are faced with a growing need to accurately determine the in-state profits of multinational businesses operating within their borders so that these entities may shoulder their fair share of the cost of maintaining the infrastructure of society. In the absence of any significant federal guidance, the states have been asked to devise taxing systems which accomplish the goal of fair apportionment of income without unduly burdening business and without violating the inherent constraints of the Commerce Clause of the United States Constitution, art. 1, Sec 8, cl. 3., most importantly, the prohibition against discriminatory taxation. The importance and complexity of this issue is brought home by the fact that on seven different occasions in the last twenty-seven years this court has addressed the issue of how and when the states may impose a tax on income which has its origins in both domestic and international commerce. *See, Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425 (1980); *Exxon Corp. v. Wisconsin Dept. of Rev.,* 447 U.S. 207 (1980); *ASARCO, Inc. v. Idaho State Tax Commissioners,* 458 U.S. 307 (1982); *F.W. Woolworth & Co. v. Taxation and Revenue Department,* 458 U.S. 354 (1982); *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159 (1983); *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance,* 505 U.S. 71 (1992); and *Barclays Bank PLC v. Franchise Tax Board,* 512 U.S. 298 (1994).

Five of these seven cases concern the inclusion of foreign-source dividends in the apportioned tax base of corporate taxpayers. The present case involves an attempt to resolve the "foreign dividend wars" which have raged across the state tax world for so many years. It is a resolution suggested by Justice Stevens' dissent in *Mobil v. Vermont,* and one which is based on the fundamental unitary taxation principles underlying *Container Corporation v. Franchise Tax Board* and *Barclays Bank PLC v. Franchise Tax Board*—factor representation of unitary dividend-paying foreign subsidiaries. This case, in which the state agreed to provide factor representation of unitary foreign dividend payors as a means of eliminating the potential of discriminatory treatment of foreign commerce, offers a significant opportunity to end decades of confusion and controversy.

The New Mexico Supreme Court held below that the Detroit formula failed to remedy the discrimination identified in *Kraft* simply because the resulting tax for these two taxpayers was higher under formulary apportionment than it would have been with dividend exclusion under arms-length accounting. But the court's conclusion ignores the very crux of the unitary business theory, which attempts to capture the synergistic relationships between related companies. (The unitary business theory is especially adept at capturing income artificially shifted to "shell" corporations, since the true value of these entities is measured by their property, payroll and sales, not paper profits.) Moreover, the lower court turned the concept of facial discrimination upon its head by looking at the tax consequences for these two taxpayers, not how the law worked when applied system-wide. The New Mexico Supreme Court's decision will

inevitably discourage principled and measured reaction to the problems which arise as the states attempt to adapt their taxing systems, which are universally based on formulary apportionment principles, to the problems of international taxation, which are based on arms-length accounting standards and citizenship-based primary taxing jurisdiction.

A. The Foreign Commerce Clause Requires Equal Burdens on Foreign and Domestic Commerce—There is no Requirement of Parallel Dividend Treatment

In *Kraft*, the Court held that states which allow separate entity filing could not automatically follow the federal tax treatment of dividend income received from foreign and domestic sources without also adopting some mechanism to avoid discrimination against foreign commerce. The *Kraft* decision has had a significant impact on the states since virtually all states use federal taxable income as their starting point for determining the net income of taxpayers. The discrimination the Court identified in *Kraft* arose from the fact that under Section 243 of the IRC, dividends paid from domestic corporations are substantially deducted from taxable income,[3] but foreign-source dividends are generally not entitled to any deduction. The IRC allows the domestic

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[3]26 U.S.C. § 243 (1996) provides that a corporate taxpayer may generally deduct 100% of the dividends received from a domestic corporation owned 80% or more by the taxpayer. A taxpayer may deduct 80% of the dividends received from a domestic corporation owned 20% or more. Dividends received by a taxpayer from a domestic corporation in which the taxpayer has less than a 20% ownership are allowed a 70% deduction.

dividend deduction on the theory that the profits of the domestic dividend payors have already been subject to federal tax; taxing the dividends again in the hands of the recipient would amount to double taxation of the payor's profits. *See, Kraft at* 505 U.S. at 73; 1 *Federal Income Taxation of Corporations and Shareholders*, ¶ 5.06. The different treatment of dividends under the IRC is countered, however, by the allowance of a foreign tax credit for "withholding" taxes paid by a U.S. taxpayer or its subsidiaries to a foreign government. The tax credit mechanism reduces the likelihood of double taxation of the same income, while maintaining the principle of primary taxation based on citizenship. No state has chosen to adopt the complex federal foreign tax credit system. 1 *Multistate Corporate Tax Guide*, pp. 246-248.

The Court in *Kraft* concluded that Iowa's disparate treatment of foreign and domestic dividends discriminated against foreign commerce because a taxpayer receiving dividends from a unitary foreign subsidiary would inevitably pay more tax than a equally situated taxpayer receiving dividends from a domestic subsidiary. The Court noted that Iowa would have to make some adjustment to its taxing system, suggesting adoption of a foreign tax credit as one alternative. In response to the *Kraft* decision, Iowa simply abandoned any attempt to include unitary foreign-source dividends in the tax base (1993 Iowa Corp. Income Tax Instr., p. 1), as did Pennsylvania (72 P.S. § 7401(3)1.(b) (1994)), and Rhode Island (*Dart Industries, Inc. v. Clark*, 619 A.2d 1062, 1066, fn. 5 (R.I. 1995)).

New Mexico agrees with the result reached in *Kraft*, but maintains that foreign dividend exclusion is not the only route

to eliminate the unequal burden on foreign commerce identified by the Court. Adjustment of the apportionment formula to reflect the contributions of the taxpayers' overseas subsidiaries accomplishes the same result, but does so in a manner which more accurately apportions earnings among unitary corporations. To the extent a foreign subsidiary's property, payroll and sales are located outside of the state, inclusion of its factors eliminates the tax burden on those earnings. This is the essence of all formulary apportionment systems, whether applied to a single corporation, or a group of unitary corporations operating within a single country, or a world-wide group of unitary corporations: to the extent earnings are included in the apportioned base, so too are the factors of the companies generating those earnings. Like world-wide combined reporting, the Detroit formula ensures that the state does not tax extra-territorial income while it eliminates the possibility of "income shifting" through inadvertent errors in transfer pricing or the deliberate manipulation of the same.[4]

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[4]As Professor Hellerstein notes in his treatise, the argument that the states should rely on the IRS's authority to adjust transfer prices between related entities under 26 U.S.C. § 482 was dealt a severe blow in 1981 when the Government Accounting Office concluded in a report to Congress that the system simply wasn't working. *State Taxation, Corporate Income and Franchise Taxes*, ¶ 8.10[7][a]. The GAO recommended that the IRS investigate the use of formulary apportionment because "in the modern economic system of multinational corporate business, a true arms-length price can rarely be identified." *Id. See also, GAO Report 92-89, Problems Persist in Determining Tax Effects of Intercompany Prices* (1992).

The New Mexico Supreme Court concluded that the state could not use the Detroit formula to eliminate the discrimination identified in *Kraft* since the results of formulary apportionment would rarely equal the results of arms-length dividend exclusion. Yet, nothing in the *Kraft* decision counsels mirror-image treatment of foreign and domestic dividends. To the contrary, the Court insisted that it was concerned with the unequal burden imposed on foreign commerce generally, not dividend treatment:

> Iowa and Amicus the United States assert the stronger claim that Iowa's tax system does not favor business activity in the United States *generally* over business activity conducted abroad. If true, this would indeed suggest that the statute does not discriminate against foreign commerce.

505 U.S. at 79-80. (emphasis added).

In addition, neither of the two taxing systems suggested by the Court as non-discriminatory—domestic combined reporting (505 U.S. at 82, fn. 23)[5] or adoption of a foreign

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[5]The highest courts of Kansas and Maine have concluded that inclusion of foreign-source dividends on a domestic combined filing return does not present a facial discrimination problem. *In re Morton Thiokol,* 254 Kan. 23, 864 P.2d 1175 (1993); *du Pont v. State Tax Ass'r,* 595 A.2d 1039 (Me. 1996). The state argued below that taxpayers' failure to use the domestic combined filing option available to them precluded a discrimination claim based on dividend treatment under separate entity filing. The New Mexico Supreme Court held that each filing method stood on its own, and expressed doubts that this Court intended to endorse combined filing in fn. 23.

tax credit (505 U.S. at 79)—follow parallel treatment of foreign and domestic dividends. This Court's Commerce Clause jurisprudence has never been concerned with distinctions of form. Instead, the Court has measured discrimination "in terms of dollars and cents, not legal abstractions." *Associated Industries v. Lohman,* 511 U.S. 641, 654 (1994). The lower court erred by failing to understand that the discrimination the Court sought to remedy in *Kraft* was not different treatment of line items on a tax return, but an unequal burden placed on foreign commerce.

B. The New Mexico Supreme Court's Facial Discrimination Analysis Is Badly Flawed

A second disturbing aspect of the decision below is the court's analysis of the proper standard for evaluating the efficacy of a state's remedy to a facial discrimination claim. The court begins by rejecting the application of *United States v. Salerno,* 481 U.S. 739 (1987), which holds that a person alleging facial discrimination must demonstrate that the challenged statute cannot operate constitutionally in any set of circumstances. The lower court goes on to distinguish *Reno v. Flores,* 507 U.S. 292 (1993) and numerous other Supreme Court cases rejecting facial discrimination challenges brought under the Due Process Clause, concluding that taxpayers alleging discrimination under the Foreign Commerce Clause face a much lower burden of proof. The lower court does not go on to identify what test should be applied under the Foreign Commerce Clause to evaluate facial discrimination claims. The apparent basis for the court's theory—other than a highly suspect exercise in "counting noses" from dissenting and concurring opinions—is the conclusion that the "no set of circumstances test" was not

applied in *Kraft* itself. Once again, the lower court has misconstrued *Kraft*. The majority for the Court correctly concluded that the higher tax burden placed on a corporation receiving dividends from a foreign subsidiary was systematic and inevitable. Iowa's suggestion that taxpayers could have avoided its tax on foreign commerce by incorporating a new subsidiary to act as a front or holding company to receive foreign dividends was rejected because the state's hypothesis was not based on two equally situated taxpayers.[6] The majority in *Kraft* correctly concluded that, as between two otherwise identical taxpayers, the taxpayer with the foreign subsidiary *always* paid more tax.

A facially discriminatory statute systematically places an unequal burden on a disfavored group. One simply cannot say that foreign commerce inevitably bears a heavier burden than domestic commerce because the former is subject to formulary apportionment and the latter, arms-length accounting. Certainly, the taxpayers below never raised such a claim. As the Court noted in *Container*, both geographic accounting and formulary apportionment are: "imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory." 463 U.S. at 183. Neither system is inherently more favorable to taxpayers than the other. *See, e.g., GTE & Subsidiaries v. Revenue Cabinet*, 889 S.W.2d 788 (Ky. 1994) (taxpayer successfully petitioned to file on a unitary combined basis).

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[6]Instead of comparing the tax liabilities of two single corporations receiving dividends from foreign and domestic sources, respectively, Iowa's example compared a single corporation to a group of corporations, some of them operating outside the state.

It is clear that the New Mexico Supreme Court confused different treatment with discriminatory treatment.

The lower court's conclusion that the Detroit formula facially discriminates because these two taxpayers pay higher taxes under the new system than they would have paid with dividend exclusion under the former system runs contrary to *McKesson Corporation v. Division of Alcoholic Bev. and Tobacco,* 496 U.S. 18 (1990) and *Tyler Pipe Industries v. Washington Dept. of Revenue,* 483 U.S. 232, 244 (1987). In *McKesson,* the Court made clear that, once a statute has been declared unconstitutional, a state is free to retroactively impose a remedial system which "levels the playing field", that is, a system which eliminates the discrimination as to the affected class as a whole. 496 U.S. at 40-41. Whether a particular taxpayer pays more or less than it would have paid under the former system is quite beside the point. If followed by other states, the lower court's holding would eviscerate *McKesson,* as states would be unable to reform their statutes on a retroactive basis. Instead, states would be left with the sole option of providing refunds, even where, as here, the refunds can only be called fortuitous.[7]

While the lower court's decision is in direct conflict with *Fulton Corp. v. Faulkner,* __ U.S. __, 116 S.Ct. 848 (1996), *Harper v. Virginia,* 509 U.S. 86 (1993) and *Digital Equipment Corp. v. Washington,* 129 Wash. 2d 177,

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[7]Conoco's "state tax expert" conceded at the formal hearing that application of the Detroit formula resulted in a fair apportionment of Conoco's income to the state. The additional refund of $365,000 ordered by the lower court must accordingly be described as a windfall. Intel's $1.9 million claim falls in the same category.

916 P.2d 933 (1996), one cannot assume that it will be ignored by other courts and legislatures as future problems arise.[8]

C. The Detroit Formula Represents a Principled Resolution of the Foreign Dividend Wars

The controversy over state taxation of foreign-source dividends has continued for decades. *See, e.g.*, 1 *State Taxation, Corporate Income and Franchise Taxes*, ¶ 9.12[1-3], and articles listed therein. Many states, including New Mexico, have maintained that the income-producing activities which generate unitary dividends are adequately represented in the gross receipts (sales) factor of the apportionment formula, equating dividends with a return on a taxpayer's business investment. Taxpayers have countered that foreign-source dividends represent the earnings of a distinct entity, requiring either exclusion of dividends from the base or inclusion of all of the foreign subsidiary's factors. The taxpayers' position was eloquently voiced by Justice Stevens

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[8]It is also significant that the lower court made no attempt to apply the traditional discrimination tests of internal and external consistency put forth by this Court in *Container* and *Armco v. Hardesty*, 467 U.S. 638 (1984). The Detroit formula is internally consistent for the same reasons that worldwide combined reporting is internally consistent. The multiple taxation of earnings in the form of dividends is eliminated through the addition of the factors of the dividend payors in the apportionment formula. And the Detroit formula meets external consistency requirements as well. Neither taxpayer in this case has alleged that New Mexico has taxed more than its fair share of their income under the Detroit formula.

in his dissent in *Mobil Oil Co. v. Commissioner of Taxes*, 445 U.S. 425 (1980), in which he wrote:

> Unless the sales, payroll and property values connected with the production of income by the payor corporations are added to the denominators of the apportionment formula, the inclusion of earnings attributable to those corporations will inevitably cause Mobil's Vermont income to be overstated.
>
> Either Mobil's worldwide "petroleum enterprise" ... is part of one unitary business, or it is not; if it is, Vermont must evaluate the entire enterprise in a consistent manner.

Justice Stevens correctly perceived that worldwide combined reporting, which includes the factors of foreign subsidiaries, offers the best solution to the problem of fair apportionment of internationally-generated income. Most states have backed away from worldwide reporting, however, in the face of strong industry protests. *Barclays Bank, supra.* The Detroit formula meets Justice Stevens' concerns while preserving the right of states to fairly apportion unitary income.

One of the ironies in the present case is that factor representation of foreign subsidiaries is something which industry has been clamoring for, and which the states have by and large resisted, ever since the *Mobil* decision. *See, e.g., NCR Corp. v. Commissioner of Revenue,* 438 N.W.2d 86 (Minn. 1989) *cert. den.*, 493 U.S. 848 (1989); *NCR Corp. v. New Mexico Taxation and Revenue Department,* 115 N.M. 612, 856 P.2d 982 (Ct. App. 1993), *cert. den.*, 512 U.S. 1245 (1984).

Two state courts have cited the Detroit formula as an appropriate answer to the competing concerns of taxpayers and the states. In *Tambrands v. State Tax Assessor,* 595 A.2d 1039 (Me. 1993), the Maine Supreme Court held that foreign-dividend taxation without factor representation failed the "internal consistency" test, remanding the case back to the state assessor's office to devise a formula for representation of foreign-source earnings. 595 A.2d at 1045. The state's response was the "Augusta formula", which allows factor representation of foreign-source dividend payors, but only where the taxpayer's liability to the state under a domestic combined return exceeds the taxpayer's liability under a world-wide combined report.[9] The "Augusta formula" was recently upheld in *E.I. du Pont de Nemours Corporation v. Assessor,* 675 A.2d 82 (Me. 1996). The Maryland Court of Appeals also suggested that factor representation of foreign dividend payors was appropriate whenever dividends were included in the tax base, although constitutionally required only where a gross distortion of income would otherwise occur. *NCR Corporation v. Comptroller,* 313 Md. 118, 544 A.2d 764 (1988).

After *Kraft,* it seems clear that the states' position that dividends are strictly internal earnings cannot be maintained, at least where federal income standards are used in separate entity filing systems, since the IRC implicitly treats domestic

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[9] The factor relief formula adopted by the state of New Mexico is significantly more favorable to taxpayers than the formula approved by the Maine Supreme Court, for it has no cap or other limitations based on results in particular cases. A taxpayer may end up receiving a higher refund or a lower refund than it would have received through dividend exclusion.

dividends as the previously-taxed earnings of a separate entity. It does not follow that unitary foreign-source dividends must be excluded from the base, nor does it follow that 100% of a subsidiary's factors should be included where less than all of the subsidiary's earnings are repatriated as a dividend. The Detroit formula properly limits the percentage of factors included in the formula to the ratio of dividends received to subsidiary net earnings.

The facial discrimination problem identified in *Kraft* and the income distortion problem identified by Justice Stevens in *Mobil* are one and the same. Factor representation of the taxpayer's unitary foreign subsidiaries is the appropriate remedy in both cases. If left unchallenged, the New Mexico Supreme Court's erroneous analysis of the discrimination identified in *Kraft*, and its subsequent rejection of formulary apportionment as a remedy for that discrimination, will discourage states from attempting to fairly tax income which has its origin both within the U.S. and overseas. *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977) (removing immunity of interstate commerce from fairly apportioned state taxes). Inevitably, if a zone of protected commerce is created for corporations engaged in multinational activities, purely domestic commerce will be made to pay more than its fair share.

CONCLUSION

The State of New Mexico prays for an order granting its Petition for a Writ of Certiorari in this case.

Respectfully submitted,

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APPENDIX A

CONOCO, INC., and Intel Corporation,
Plaintiffs-Petitioners,

v.

TAXATION AND REVENUE DEPARTMENT
OF the STATE OF NEW MEXICO,
Defendant-Respondent.

Nos. 22995, 23045.

Supreme Court of New Mexico.

Nov. 26, 1996.

Rehearing Denied Jan. 23, 1997.

Multijurisdictional corporate taxpayers sought refund of taxes paid by them as separate corporate entities over and above their tax liabilities if dividends received from foreign subsidiaries had been deducted from their respective tax bases. Hearing officers for state Taxation and Revenue Department denied refunds. Taxpayers separately appealed. The Court of Appeals, Apodaca, C.J., 1995 WL 424128, affirmed denial of refund to one taxpayer and held that second taxpayer's appeal was governed by its decision with respect to other taxpayer. Taxpayers appealed and appeals were consolidated. The Supreme Court, Ransom, J., held that: (1) taxing dividends from foreign subsidiaries under separate corporate entity method, even with "Detroit formula" for reducing base income, violated foreign commerce clause; (2) taxpayers did not have to prove that scheme discriminated against every conceivable taxpayer to prove that tax was facially discriminatory; and (3) taxpayers were entitled to refunds.

Reversed.

Modrall, Sperling, Roehl, Harris & Sisk, P.A., Curtis W. Schwartz, Timothy C. Holm, Santa Fe, Morrison & Foerster, Paul H. Frankel, Walter Hellerstein, Hollis L. Hyans, Irwin M. Slomka, New York City, for Petitioners.

Tom Udall, Attorney General, Bruce J. Fort, Special Assistant Attorney General, Santa Fe, for Respondent.

Mack Easley, Albuquerque, for Amicus Curiae Committee on State Taxation.

Taichert, Wiggins, Virtue & Najjar, Daniel A. Najjar, Santa Fe, for Amicus Curiae Intel Corporation.

OPINION

RANSOM, Justice.

1. We here review the constitutionality of New Mexico's formulaic tax scheme for dividends received by a parent corporation from its foreign subsidiaries notwithstanding that dividends received from domestic subsidiaries are excluded entirely from the parent's tax base. This opinion has been amended pursuant to order entered January 23, 1997, in response to motions for clarification and reconsideration. Conoco, Inc., and Intel Corporation had sought the refund of taxes paid by them as separate corporate entities for 1988, 1989, and 1990 over and above their tax liabilities if dividends received from foreign subsidiaries had been deducted from their respective tax bases. Hearing officers for the New Mexico Taxation and Revenue Department denied the refunds. In the Conoco case the hearing officer also upheld an assessment issued by the Department against Conoco for

underpaid taxes for 1991. Conoco and Intel each appealed to the Court of Appeals.

2. The Court of Appeals decided Conoco's case first and held that the applicable New Mexico corporate income tax scheme does not treat dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries and therefore is not violative of the Foreign Commerce Clause of the United States Constitution, Article I, Section 8, Clause 3. *Conoco, Inc. v. Taxation & Revenue Dep't*, ___ N.M. ___, 931 P.2d 739 (Ct.App.1995). We granted certiorari, 120 N.M. 68, 898 P.2d 120 (1995), and allowed Intel to file an amicus curiae brief. The Court of Appeals then held in an unpublished memorandum opinion that the Intel appeal was governed by its decision in *Conoco*. We granted certiorari for consolidation with Conoco. We find that the applicable New Mexico corporate income tax scheme is unconstitutional, and we reverse the Court of Appeals.

3. *The Taxpayers*. Conoco and Intel both conduct business in New Mexico. Conoco's primary business in New Mexico is exploration, production, and distribution of oil and gas products. Conoco is a wholly owned subsidiary of E.I. Du Pont de Nemours and Company. Intel's primary business in New Mexico is the manufacture of microcomputer components. Both corporations conduct business worldwide through numerous domestic and foreign subsidiaries. None of the foreign subsidiaries conduct business in New Mexico. During all relevant years, both Conoco and Intel filed New Mexico corporate income tax returns as "separate corporate entities."

4. *New Mexico tax scheme.* In *Conoco*, reported immediately following our instant opinion, Chief Judge Apodaca of the Court of Appeals provides a discussion of the New Mexico corporate income tax scheme. Aside from the Foreign Commerce Clause, on which this case turns, there are other constraints on a state's power to tax multijurisdictional business entities. The Due Process Clause of the Fourteenth Amendment requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. v. Maryland*, 347 U.S. 340, 344-45, 74 S.Ct. 535, 539, 98 L.Ed. 744 (1954). A state tax on business activities occurring outside the state satisfies the due process clause only if "the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444, 61 S.Ct. 246, 249, 85 L.Ed. 267 (1940), *quoted in ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315, 102 S.Ct. 3103, 3108, 73 L.Ed.2d 787 (1982). To ensure that the state does not tax value attributable to business conducted outside of the state, a state must use some type of apportionment formula to determine what income was earned within the state and also what portion of income earned extraterritorially is attributable to the corporation's in-state business activity. *See Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439-40, 100 S.Ct. 1223, 1232-33, 63 L.Ed.2d 510 (1980).

5. To a corporate taxpayer's base income New Mexico applies an apportionment formula pursuant to the Uniform Division of Income for Tax Purposes Act, NMSA

1978, §§ 7-4-1 to -21 (Repl.Pamp.1995) ("UDITPA"). UDITPA uses a three-part formula to apportion income between that which is subject to New Mexico taxation and that which is not. This apportionment method divides a corporation's assets into a property factor, a payroll factor, and a sales factor. *See* NMSA 1978, § 7-4-10 (Repl.Pamp.1995). To determine each of the factors, the in-state value of an asset is divided by the total value of the asset (including in-state and out-of-state value). The resulting three fractions are then added together and divided by three to create a multiplier that is applied to the corporation's total income. This calculation yields the apportioned income that is subject to taxation in New Mexico. *Id.* As discussed later under the "Detroit formula" heading, the Department has attempted to similarly apportion foreign subsidiary dividends to satisfy Foreign Commerce Clause considerations. Whether the Detroit formula satisfies the Foreign Commerce Clause is the determinative issue of this case.

6. – *Separate corporate entity.* During the years relevant to this case, corporations filing tax returns in New Mexico could choose from four different income reporting methods: separate accounting, separate corporate entity, combination of unitary corporations, or federal consolidated group. See Regulations Pertaining to the Corporate Income and Franchise Tax Act, N.M. Tax. and Rev. Dep't, Rule CIT 9:2(B) (1992) (Reporting Methods). Both Conoco and Intel elected to file according to the separate corporate entity method, in which the corporation reports its entire income, to which an apportionment formula is then applied. Under this method a corporation reports income separate from the rest of a unitary group

or a group defined by the federal consolidated method. The income *of* subsidiary corporations is not reported or considered for apportionment. *Id.* at 2:10 (Separate Corporate Entity).

7. Like at least thirty-nine other states, New Mexico uses a corporate taxpayer's federal taxable income, with the deductions allowed by 26 U.S.C. § 243 (1988), as the "base income" for state income tax purposes. *See* NMSA 1978, § 7-2A-2(C) (Repl.Pamp.1995). Since the entire earnings of domestic subsidiaries are already subject to federal taxation, section 243 of the Internal Revenue Code avoids multiple taxation by allowing corporations to deduct dividends received from domestic subsidiaries. Therefore, dividends from domestic subsidiaries are not included in federal taxable income. To eliminate multiple taxation of earnings of foreign subsidiaries, the federal government allows a subsequent credit to corporations for taxes paid to foreign governments. 26 U.S.C. § 901 (1988). However, dividends from foreign subsidiaries are initially included in federal taxable income. By using federal taxable income as a base, New Mexico excludes domestic but includes foreign dividend income in the state base income. Conoco and Intel contend that including foreign subsidiary dividends in the calculation of New Mexico taxable income while excluding domestic subsidiary dividends facially discriminates against foreign commerce in violation of the Foreign Commerce Clause. *See Kraft Gen. Foods v. Iowa Dep't of Revenue*, 505 U.S. 71, 112 S.Ct. 2365, 120 L.Ed.2d 59 (1992).

8. In *Kraft*, the U.S. Supreme Court held that Iowa's corporate income tax scheme facially discriminated against foreign commerce in violation of the Foreign

Commerce Clause. Iowa, like New Mexico, used federal taxable income as the base income for state income tax purposes, but unlike New Mexico it did not apply the Detroit formula. Iowa made several arguments in support of the proposition that its differential treatment did not constitute prohibited discrimination, but each of these arguments was rejected by the Court. *Id.* at 74-82, 112 S.Ct. at 2368-72. The Court held that the fact corporations could change their domicile or corporate structure to avoid the disparate effects of the tax did not make the tax constitutional. *Id.* at 74-78, 112 S.Ct. at 2368-69. The Court also rejected Iowa's argument that because the tax did not favor local commerce it did not violate the Foreign Commerce Clause. "As the absence of local benefit does not eliminate the international implications of the discrimination, it cannot exempt such discrimination from Commerce Clause prohibitions." *Id.* at 79, 112 S.Ct. at 2370.

9. Iowa's claim that its tax scheme was intended to promote administrative convenience rather than economic protectionism was also insufficient to make it valid. *Id.* at 81-82, 112 S.Ct. at 2371-72. While adopting the federal definition of "taxable income" may bring significant benefits in terms of administrative convenience to both Iowa taxpayers and tax collectors, the Court found these benefits were not the sort of "compelling justification" capable of saving a statute that facially discriminates against foreign commerce. *Id.* (citing *Philadelphia v. New Jersey*, 437 U.S. 617, 626-28, 98 S.Ct. 2531, 2536-38, 57 L.Ed.2d 475 (1978); *Maine v. Taylor*, 477 U.S. 131, 148, n. 19, 106 S.Ct. 2440, 2453, n. 19, 91 L.Ed.2d 110 (1986)). The Court observed that "Iowa could enjoy substantially the

same administrative benefits by utilizing the federal definition of taxable income, while making adjustments that avoid the discriminatory treatment of foreign subsidiary dividends." *Id.* 505 U.S. at 81, 112 S.Ct. at 2371. In the wake of *Kraft*, other states' corporate tax schemes have come under Foreign Commerce Clause scrutiny, with varied results.

10. In *Dart Industries, Inc. v. Clark*, 657 A.2d 1062, 1066 (R.I.1995), the Supreme Court of Rhode Island held that Rhode Island's corporate tax scheme violated the Foreign Commerce Clause because of its similarity to the tax scheme invalidated in *Kraft*. Like Iowa and New Mexico, Rhode Island included dividend income from foreign subsidiaries in the tax base of the parent corporation, but excluded dividend income from domestic subsidiaries. In calculating its net income for the tax years in question, Dart Industries, like Conoco and Intel in this case, excluded foreign dividend income. After reviewing the Rhode Island tax scheme, the *Dart* court held that *Kraft* was controlling.

> In a manner similar to the Iowa statute at issue in *Kraft*, Rhode Island's [tax scheme] treats dividends paid by a foreign corporation less favorably than those paid by domestic corporations. Although the Rhode Island and Iowa statutes differ in minor respects, the fatal flaw in the Iowa statute is present in [the Rhode Island statute]: a preference for domestic commerce over foreign commerce. As such, we are compelled to hold that [the Rhode Island scheme] "facially discriminates against foreign commerce and therefore violates the Foreign Commerce Clause."

Id. at 1066 (quoting *Kraft*) (citations omitted).

11. In *In re Appeal of Morton Thiokol, Inc.*, 254 Kan. 23, 864 P.2d 1175 (1993), the Supreme Court of Kansas upheld a state corporate income tax scheme utilizing the domestic combination method of apportionment. Under this method, a member of a unitary corporation, whose "various parts are interdependent and of mutual benefit so as to form one integral business," is taxed on the apportioned share of the income of all members doing business in the United States, regardless of country of origin, and dividends paid by foreign subsidiaries. *Id.* at 24-25, 864 P.2d at 1178. The court noted the analogies between this tax scheme and Iowa's, but determined that the inclusion of income of domestic subsidiaries into the parent's tax base distinguished Kansas' scheme from Iowa's.

> [In *Kraft*, t]he Supreme Court compared a parent corporation with a domestic subsidiary which does not do business in Iowa to a parent corporation with a foreign subsidiary which does not do business in Iowa. In this comparison, Iowa discriminated against the parent corporation with the foreign subsidiary because Iowa allowed a deduction for the dividends received by the parent with the domestic subsidiary, but not for the dividends received by the parent with the foreign subsidiary. . . . [However,] *Kraft* "does not address the taxation of foreign dividends by domestic combination states." Clearly, *Kraft* does not hold that the taxation of foreign dividends by a combination method is facially unconstitutional. . . . Allowing a deduction for the domestic dividend avoids double taxation. It is the use of the domestic combination method which distinguishes the Kansas and Iowa tax schemes.

Id. at 37-39, 864 P.2d at 1186 (quoting argument of Department of Revenue).

12. Most recently, the Maine Supreme Judicial Court upheld the constitutionality of Maine's corporate tax scheme, which utilizes the "water's edge combined reporting method." *E.I. Du Pont de Nemours & Co. v. State Tax Assessor,* 675 A.2d 82, 84-85 (Me.1996). Under this method of apportionment, income earned by domestic subsidiaries is included in the amount apportioned to Maine. Thus Maine directly taxes an apportioned part of the domestic subsidiary's income. "Maine's use of the water's edge combined reporting method limits the State to the nation's boundaries in calculating corporate income, and hence no income of foreign subsidiaries is apportioned to Maine." *Id.* at 87. The Assessor adds foreign subsidiary dividends paid to the domestic parent "because these dividends represent value earned by the parent that is not otherwise captured." *Id.* at 87-88. Echoing the reasoning of the *Morton Thiokol* court, the *Du Pont* court noted that "[i]n *Kraft,* the Supreme Court considered the constitutionality only of Iowa's single entity reporting system." *Id.* at 87. The court held that *Kraft* did not apply to the Maine tax scheme because "[f]ar from discriminating against foreign commerce, Maine's water's edge combined reporting method provides a type of 'taxing symmetry' that is not present under the single entity system." *Id.* at 88.

> Although the dividends paid to parent corporations with domestic subsidiaries are not taxed, the apportioned income of the domestic subsidiaries is subject to tax. Because the income of the unitary domestic affiliates is included, apportioned, and ultimately directly taxed by Maine as part of the parent company's income, the

> inclusion of dividends paid by foreign subsidiaries does not constitute the kind of facial discrimination against foreign commerce that caused the Supreme Court to invalidate Iowa's tax scheme in *Kraft*. Thus, Maine's use of a water's edge combined reporting method distinguishes Maine's taxing scheme from the scheme invalidated by the United States Supreme Court in *Kraft*.

Id. Like the Supreme Court of Kansas in *Thiokol*, the *Du Pont* Court was able to distinguish the challenged tax scheme from Iowa's tax scheme because Maine included a portion of the domestic subsidiaries' income in the tax base of the parent. However, this "taxing symmetry" is not present in the New Mexico tax scheme.

13. The tax schemes of Kansas and Maine have been upheld as distinguishable from the Iowa and Rhode Island schemes invalidated in *Kraft* and *Dart*. New Mexico's corporate tax scheme is virtually identical to Iowa's and Rhode Island's, except for its use of the Detroit formula. Therefore, the New Mexico tax scheme violates the Foreign Commerce Clause unless saved by the Detroit formula.

14. – *The Detroit formula.* The Detroit formula, named after an agreement between the Ford Motor Company and the city of Detroit, operates to reduce the New Mexico taxable income base by adding into the denominators of the parent corporation's property, payroll, and sales a portion of the property, payroll, and sales of dividend-producing foreign subsidiaries. *See* Regulation UDI 19:10 (issued March 17, 1994, effective retroactively

to January 1, 1988). This portion is determined by dividing the net dividends the parent corporation receives from foreign subsidiaries by these subsidiaries' total net profit. *Id.* This addition into the divisors lowers the fractional multiplier used against a taxpayer's total income, which lowers its New Mexico taxable income base.

15. The Department argues that the application of the formula remedies the differential treatment of domestic and foreign commerce under the New Mexico tax scheme by thus reducing the taxable income base. The formula, however, does not eliminate dividends paid by foreign subsidiaries in every case. In particular, it did not do so in these two cases. The hearing officer below found that the Taxpayers were paying more taxes under the Detroit formula than if the dividends from foreign subsidiaries were excluded. The hearing officer also stated that it was doubtful that every dollar paid by foreign subsidiaries was excluded from the tax base through the application of the Detroit formula. *Kraft* clearly requires that foreign and domestic commerce be treated equally, and the New Mexico tax scheme fails to do this, even with the Detroit formula.

16. As the Supreme Judicial Court of Massachusetts noted with respect to discriminatory taxes in interstate commerce, "the extent of the economic burden imposed by the excise 'is of no relevance to the determination whether a State has discriminated against interstate commerce.' " *Perini Corp. v. Commissioner of Revenue,* 419 Mass. 763, 770, 647 N.E.2d 52, 57 n. 7 (1995) (quoting *Wyoming v. Oklahoma,* 502 U.S. 437, 455, 112 S.Ct. 789, 800-01, 117 L.Ed.2d 1 (1992)). "When a tax, on its face, is designed to have discriminatory economic effects, the

Court 'need not know how unequal the Tax is before concluding that it unconstitutionally discriminates.' " *Id.* (quoting *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 406-07, 104 S.Ct. 1856, 1867-68, 80 L.Ed.2d 388 (1984) (quoting *Maryland v. Louisiana*, 451 U.S. 725, 760, 101 S.Ct. 2114, 2136, 68 L.Ed.2d 576 (1981))). Accordingly, we hold that taxing of dividends from foreign subsidiaries under the separate corporate entity method is unconstitutional, even with the Detroit formula.

17. *Taxpayers' burden of proof.* The Department relies on the Taxpayers' failure to meet their burden of proof under *United States v. Salerno*, 481 U.S. 739, 107 S.Ct. 2095, 95 L.Ed.2d 697 (1987), in which the Court required a defendant challenging pretrial detention based on future dangerousness under the Bail Reform Act to show that "no set of circumstances exists under which the Act would be valid. The fact that the Bail Reform Act might operate unconstitutionally under some conceivable set of circumstances is insufficient to render it wholly invalid. . . . " *Id.* at 745, 107 S.Ct. at 2100. Dissenting in *Kraft*, Chief Justice Rehnquist unsuccessfully argued for the application of the no-set-of-circumstances test, quoting this language from *Salerno*. *Kraft*, 505 U.S. at 82-83, 112 S.Ct. at 2371-72 (Rehnquist, C.J., dissenting). The Department interprets this language to mean that the Taxpayers have the burden of proving that New Mexico's corporate income tax scheme discriminates against every conceivable taxpayer in order to prove that the tax is facially discriminatory.

18. This language in *Salerno* and subsequent cases involving due process challenges lend some support to the proposition that Salerno articulated the burden of

proof for any facial challenge to the constitutionality of a statute. *See Reno v. Flores*, 507 U.S. 292, 300, 113 S.Ct. 1439, 1446, 123 L.Ed.2d 1 (1993) (applying *Salerno* to due process challenge to Immigration and Naturalization Service regulations regarding release of alien juveniles from detention); *Rust v. Sullivan*, 500 U.S. 173, 183, 111 S.Ct. 1759, 1767, 114 L.Ed.2d 233 (1991) (applying *Salerno* to uphold Health and Human Services regulations limiting ability of Title X fund recipients to engage in abortion-related activities); *Caplin & Drysdale v. United States*, 491 U.S. 617, 634, 109 S.Ct. 2646, 2657, 105 L.Ed.2d 528 (1989) (requiring challenger of forfeiture action on due process grounds to show forfeiture rule was "inherently unconstitutional"); *Dean v. McWherter*, 70 F.3d 43, 45 (6th Cir.1995) (applying no-set-of-circumstances test to a Fourteenth Amendment due process challenge in upholding Tennessee law labelling sex offenders "a species of mentally ill persons in the eyes of the general assembly"); *Jordan by Jordan v. Jackson*, 15 F.3d 333, 343-44 (4th Cir.1994) (relying on no-set-of-circumstances test against due process facial challenge to uphold Virginia statute delaying judicial review of emergency child custody decisions).

19. However, the test also has been questioned. *See Janklow v. Planned Parenthood*, ___ U.S. ___, 116 S.Ct. 1582, 134 L.Ed.2d 679 (1996) (memorandum of Stevens, J., respecting denial of certiorari). Justice Stevens drew a distinction between the longstanding principle that a facial challenge to a statute must do more than show it might operate unconstitutionally in some conceivable set of circumstances and *Salerno's* "rhetorical flourish" that went well beyond that principle in requiring a litigant to

establish that there is no set of circumstances under which the statute would be valid. *Id.* at ___, 116 S.Ct. at 1583.

> That statement was unsupported by citation or precedent. It was also unnecessary to the holding in the case, for the Court effectively held that the statute at issue would be constitutional as applied in a large fraction of cases. . . . [T]he dicta in Salerno "does not accurately characterize the standard for deciding facial challenges," and "neither accurately reflects the Court's practice with respect to facial challenges, nor is it consistent with a wide array of legal principles." For these reasons, *Salerno's* rigid and unwise dictum has been properly ignored in subsequent cases even outside the abortion context.

Id. (citations omitted) (quoting *Michael C. Dorf, Facial Challenges to State and Federal Statutes,* 46 Stan.L.Rev. 235, 236, 238 (1994)). *Contra Janklow,* ___ U.S. at ___, 116 S.Ct. at 1582 (Scalia, J., joined by Rehnquist, C.J., Thomas, J., dissenting from denial of certiorari) (strongly dissenting from Justice Stevens' memorandum). In *Planned Parenthood, Sioux Falls Clinic v. Miller,* 63 F.3d 1452 (8th Cir.1995), the Eighth Circuit did not follow *Salerno* because it believed "the Court effectively overruled *Salerno* for facial challenges to abortion statutes." *Id.* at 1458 (same case as *Janklow*). In *Casey v. Planned Parenthood,* 14 F.3d 848, 863 (3rd Cir.1994), the Third Circuit questioned *Salerno* and noted that in *Planned Parenthood of Southeastern Pa. v. Casey,* 505 U.S. 833, 112 S.Ct. 2791, 120 L.Ed.2d 674 (1992), the Court did not follow *Salerno* and

apparently replaced the no-set-of-circumstances standard with the less stringent large fraction test.

20. If the application of the no-set-of-circumstances test to due process challenges is questionable, its application to this Foreign Commerce Clause challenge is even more questionable. In *Kraft* the majority declined to accept Chief Justice Rehnquist's invitation to apply *Salerno* and uphold Iowa's tax scheme. *Kraft*, 505 U.S. at 82-87, 112 S.Ct. at 2371-74. The rationale behind the Court's decision in *Kraft* is instructive. It considered and rejected an argument advanced by Iowa and the United States that corporations could avoid the differential treatment of domestic and foreign commerce if they were organized differently. *Id.* at 78, 112 S.Ct. at 2369-70. If the no-set-of-circumstances test had applied, this argument would have been persuasive since it would have shown that under some circumstances the tax could operate constitutionally. Under *Salerno*, this argument would defeat the facial challenge. The *Kraft* Court's rejection of this argument indicates that the no-set-of-circumstances test did not apply. We note also that Salerno was not applied in any of the post-*Kraft* decisions discussed above. *See Morton Thiokol*, 864 P.2d at 1184-86; *Du Pont*, 675 A.2d at 86-88; *Dart*, 657 A.2d at 1062-66.

21. While we recognize that Chief Justice Rehnquist and Justices Scalia and Thomas disagree with Justice Stevens' repudiation of Salerno in the context of challenges to abortion-related statutes and perhaps other due process challenges, we also note that Kraft indicates that the Chief Justice is alone among current members of the Court in regarding the *Salerno* test as applicable to Foreign Commerce Clause challenges to corporate income

tax schemes. *See Kraft*, 505 U.S. at 72, 112 S.Ct. at 2367 (Stevens, O'Connor, Scalia, Kennedy, Souter, and Thomas, JJ., in the majority; Rehnquist, C.J., in dissent). For this reason, and the reasons articulated above, we do not think the Taxpayers' claims fail merely because the Detroit formula may have the effect of treating dividends from domestic and foreign subsidiaries equally for certain corporations.

22. The meaning of *Kraft* is clear from the decision itself as well as from subsequent state court decisions: a state corporate income tax scheme that treats dividends from foreign subsidiaries less favorably than dividends from domestic subsidiaries facially discriminates against foreign commerce in violation of the Foreign Commerce Clause. *Id.* at 76-82, 112 S.Ct. at 2368-72; *Morton Thiokol*, 864 A.2d at 1183, 1185; *DuPont*, 675 A.2d at 86-88; *Dart*, 657 A.2d at 1066. The mere fact that there may be a set of circumstances in which the tax operates constitutionally will not suffice under Kraft to uphold the statute against a challenge to its constitutionality on Foreign Commerce Clause grounds.[1] Therefore, we find that the Taxpayers

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[1] The inapplicability of the no-set-of-circumstances test to this challenge to New Mexico's corporate income tax scheme on Foreign Commerce Clause grounds in no way affects New Mexico precedent regarding the rational basis test for equal protection challenges to classifications. *See Marrujo v. New Mexico Highway Transp. Dep't*, 118 N.M. 753, 887 P.2d 747 (1994). In *Marrujo*, we stated that we "will uphold the statute if any state of facts can be discerned that will reasonably sustain the challenged classification." *Id.* at 758, 887 P.2d at 752. *See also Richardson v. Carnegie Library Restaurant, Inc.*, 107 N.M. 688, 693, 763 P.2d 1153, 1158 (1988); *Espanola Housing Authority v. Atencio*, 90 N.M. 787, 788, 568 P.2d 1233, 1234 (1977); *Board of Trustees of*

did not have the burden of proving that the New Mexico tax scheme, which discriminated against them individually, would discriminate against every conceivable taxpayer.

23. *Voluntary election.* The Department argues that Conoco and Intel are not entitled to relief because any discrimination against foreign commerce was a result of their decision to utilize separate entity filing over other options. The Department cites footnote 23 from *Kraft* to show that the Court approved domestic combined reporting and therefore argues that the Taxpayers had the option of choosing a constitutional method of filing. The language that the Department cites reads as follows:

> If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent.

Las Vegas v. Montano, 82 N.M. 340, 343, 481 P.2d 702, 705 (1971); *Garcia v. Albuquerque Pub. Sch. Bd.*, 95 N.M. 391, 393, 622 P.2d 699, 701 (Ct.App.1981). This line of cases is still valid as an expression of the minimum scrutiny test for equal protection challenges to classifications.

Kraft, at 80, n. 23, 112 S.Ct. at 2371 n. 23. Even if the Court implicitly approved domestic combined reporting, an interpretation we are not inclined to accept and do not adopt in this opinion, the existence of constitutional options should not preclude taxpayer relief from the unconstitutional aspects of the option exercised by the taxpayer. Courts will not ignore constitutional challenges merely because the claimant could have chosen another option, the constitutionality of which is not questioned. *See Conoco*, ___ N.M. at ___, 931 P.2d at 749 (citing *Campbell v. Wood*, 18 F.3d 662, 680 (9th Cir.1994) (reviewing the constitutionality of probation conditions even though incarceration was an option to the probationer), *cert. denied*, 511 U.S. 1119, 114 S.Ct. 2125, 128 L.Ed.2d 682 (1994)). In Intel's action before the Department's hearing officer, the officer stated that

> Intel has exercised the right given it by the Secretary in Regulation CIT 9:2 to file under the separate corporate entity filing method. Having made a valid election of filing methods, Intel is entitled to have that filing method applied to it in a constitutional manner.

We agree with both the Court of Appeals and the hearing officer and find that the presence of other reporting options is not relevant to the Taxpayers' claim.

24. *Refund of collected taxes.* The Taxpayers assert that the Department must refund any taxes collected pursuant to an unconstitutional tax. It is true that the Department is authorized to make refunds under certain circumstances. *See, e.g., Neff v. State*, 116 N.M. 240, 245, 861 P.2d 281, 286 (Ct.App.1993). When a tax is found unconstitutional, the Department may "either award full

refunds to those burdened by an unlawful tax or issue some other order that 'create[s] in hindsight a nondiscriminatory scheme.' " *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 101, 113 S.Ct. 2510, 2519, 125 L.Ed.2d 74 (1993) (quoting *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 40, 110 S.Ct. 2238, 2252, 110 L.Ed.2d 17 (1990)). *See also Dart*, 657 A.2d at 1067 (requiring under Rhode Island law "a refund when a taxpayer has prepaid a tax and is subsequently successful in challenging the legality of that tax").

25. The Department apparently attempted to create a nondiscriminatory scheme with the retroactive application of the Detroit formula, but this attempt was unsuccessful. On motion for reconsideration, the Department urges this Court to remand these cases to the administrative hearing officer for a determination of an appropriate remedy. While we do not decide the appropriateness of any remedy that may be applied to other taxpayers, the Detroit-formula remedy is the only remedy the Department advanced here in response to the deduction-from-tax-base remedy advocated by Taxpayers. Serial litigation of multiple efforts to craft a remedy for specific taxpayers would be an affront to judicial economy and the principle of finality.

26. *Conclusion*. Taxation of dividends from foreign subsidiaries under the separate corporate entity method violates the Foreign Commerce Clause of the United States Constitution, and application of the Detroit-formula is an insufficient remedy. Therefore, the opinion of the Court of Appeals is reversed. The refunds sought by the Taxpayers should be allowed and the assessment levied by the Department should be abated.

27. **IT IS SO ORDERED.**

FRANCHINI, C.J., and BACA and SERNA, JJ., concur.

APPENDIX B

CONOCO, INC., Plaintiff-Appellant,

v.

STATE of New Mexico TAXATION AND REVENUE DEPARTMENT, Defendant-Appellee.

No. 15372.

Court of Appeals of New Mexico.

May 1, 1995.

Certiorari Granted June 14, 1995.

Multistate corporation sought refund of corporate income taxes based on what its tax liability would have been had foreign dividends been excluded from its apportionable tax base. The Taxation and Revenue Department, Gerald B. Richardson, Hearing Officer, denied claim for refund but reduced assessment for subsequent tax year, and appeals were taken. The Court of Appeals, Apodaca, C.J., held that: (1) New Mexico's corporate income taxation scheme did not facially violate foreign commerce clause or due process clause of Federal Constitution, and (2) substantial evidence supported hearing officer's decision to reduce assessment.

Affirmed.

Donnelly, J., dissented and filed opinion.

Curtis W. Schwartz and Timothy C. Holm, Modrall, Sperling, Roehl, Harris & Sisk, P.A., Santa Fe, for plaintiff-appellant.

Tom Udall, Atty. Gen. and Bruce J. Fort, Sp. Asst. Atty. Gen., Santa Fe, for defendant-appellee.

OPINION

APODACA, Chief Judge.

The issues in this appeal involve the New Mexico Taxation and Revenue Department's (the Department) denial of Conoco, Inc.'s (the taxpayer) refund claims for certain tax years and the Department's imposition of an assessment for the tax year 1991.

The taxpayer sought a refund of corporate income taxes paid to the State of New Mexico for the tax years 1988, 1989, and 1990, based on what its tax liability would have been had foreign dividends and Subpart F[1] income been excluded from its apportionable tax base. The Department denied the taxpayer's claims for refunds. The taxpayer also reduced its tax payments for the 1991 tax year on the same basis, prompting the Department to issue Assessment No. 1,638,288 against the taxpayer for that year.

After a formal hearing, the Department's hearing officer denied the taxpayer's claims for refunds and

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[1] "Subpart F" refers to Sections 951-964 of the Internal Revenue Code (I.R.C.). *See* 26 U.S.C. §§ 951-964 (1988). Certain types of income, including, among other things, income earned by captive insurance companies, investment companies, and other controlled foreign corporations of a domestic (United States) company in tax haven countries is deemed to be distributed to the United States parent corporation even though no formal dividend is paid. *See NCR Corp. v. Taxation & Revenue Dep't*, 115 N.M. 612, 618-20, 856 P.2d 982, 988-90 (Ct.App.), *cert. denied*, 115 N.M. 677, 857 P.2d 788 (1993), *cert. denied*, ___ U.S. ___, 114 S.Ct. 2763, 129 L.Ed.2d 877 (1994). For purposes of this appeal, the parties have stipulated that such income should be treated as a foreign dividend.

reduced the Department's assessment against the taxpayer consistent with modifications to the standard apportionment formula allowed for previous years. The taxpayer appeals.

We conclude that the hearing officer properly denied the taxpayer's claims for refunds. We also conclude that the hearing officer properly reduced the Department's assessment against the taxpayer for the 1991 tax year. We thus affirm.

I. BACKGROUND

A. Conoco, Inc.

The taxpayer is a wholly owned subsidiary of E.I. DuPont de Nemours and Company (DuPont), a Delaware corporation. The taxpayer's headquarters and principal place of business are located in Houston, Texas. DuPont and its domestic and foreign subsidiaries,[2] including the taxpayer, constitute a unitary business enterprise. Part of DuPont's unitary business enterprise consists of integrated oil and gas activities that are conducted on a worldwide basis, primarily through the taxpayer.

The taxpayer itself conducts business in all fifty states and in the District of Columbia. It also conducts business activities worldwide through the ownership of

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[2] For purposes of this opinion, "domestic subsidiaries" means subsidiary corporations incorporated in the United States whose operations are within the United States, and "foreign subsidiaries" means subsidiary corporations organized under the laws of foreign countries whose operations are outside of the United States.

stock in domestic and foreign subsidiaries. The taxpayer owns one-hundred percent of the stock of most of its foreign subsidiaries. Although its subsidiaries conduct business in approximately twenty-five countries, they typically conduct business only in the country in which they were incorporated. The taxpayer receives dividends from both its domestic and foreign subsidiaries.

B. Conoco's New Mexico Tax Returns

In tax years 1988, 1989, and 1990, without petitioning the Department as required by NMSA 1978, Section 7-4-19 (Repl.Pamp.1993),[3] the taxpayer applied the Detroit formula of factor relief[4] to its tax base in calculating its New Mexico tax liability. In late 1992, shortly after the United States Supreme Court's decision in *Kraft General Foods v. Iowa Department of Revenue & Finance*, 505 U.S. 71, 112 S.Ct. 2365, 120 L.Ed.2d 59 (1992), the taxpayer filed amended New Mexico corporate income tax returns for the tax years 1988, 1989, and 1990. Additionally, in its

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[3] Section 7-4-19 provides:

> If the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act [(UDITPA), NMSA 1978, §§ 7-4-1 through 7-4-21 (Repl.Pamp.1993)] not fairly represent the extent of the taxpayer's business activity in [New Mexico], the taxpayer may petition for, or the department may require, . . . the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state.

[4] *See infra* Section III.C.3 for a complete discussion of the Detroit formula of factor relief.

1991 return, the taxpayer totally excluded foreign subsidiary dividends as well as domestic subsidiary dividends from its tax base. Before filing its 1991 return, the taxpayer made estimated tax payments for the tax year 1991, which were $93,569 more than the tax computed for tax year 1991, based on the exclusion of foreign subsidiary dividends from the tax base. In the amended returns, the taxpayer contended that tax refunds were due because the Supreme Court's decision in *Kraft* required the Department to allow the taxpayer to deduct both domestic and foreign subsidiary dividends. The exclusion of foreign subsidiary dividend income for tax years 1988, 1989, and 1990, resulted in even lower taxes for the taxpayer than did the self-applied Detroit formula. The taxpayer claimed refunds in the following amounts: 1988: $87,064; 1989: $33,474; 1990: $144,854; and 1991: $93,569.

The taxpayer applied the Detroit formula in its calculations of its initial filings for tax years 1988, 1989, and 1990, and paid its taxes on that basis. Application of the Detroit formula, as proposed by the Department, to those tax years resulted in the same amount of taxes due as the taxpayer had already paid, but higher taxes than the taxpayer claimed on its amended returns based on the total exclusion of foreign subsidiary dividends from the tax base. Consequently, the Department denied the taxpayer's claims for refunds for the tax years 1988, 1989, and 1990. For tax year 1991, the Department also denied the taxpayer's claim for a refund in the amount of $93,569 based on the exclusion of foreign subsidiary income. The Department then issued Assessment No. 1,638,288 against the taxpayer, asserting that corporate income tax, penalties, and interest for the 1991 tax year were due. The

taxpayer protested both the refund denials and the assessment, pursuant to NMSA 1978, Section 7-1-24 (Repl.Pamp.1993). A formal administrative hearing before the hearing officer was held. In his decision, the hearing officer upheld the Department's application of the Detroit formula to calculate the taxpayer's New Mexico corporate income tax for tax years 1988-1991. The taxpayer appeals this determination.

II. STANDARD OF REVIEW

On review, this Court must determine whether the hearing officer's decision was: (1) arbitrary, capricious, or an abuse of discretion; (2) not supported by substantial evidence in the record; or (3) otherwise not in accordance with law. NMSA 1978, § 7-1-25(C) (Repl.Pamp.1993). Judicial review of administrative decisions is based on the whole record, *see* § 7-1-25(A); *Duke City Lumber Co. v. New Mexico Envtl. Improvement Bd.*, 101 N.M. 291, 293, 681 P.2d 717, 719 (1984); *Wing Pawn Shop v. Taxation & Revenue Dep't*, 111 N.M. 735, 739, 809 P.2d 649, 653 (Ct.App.1991), requiring this Court to consider not only evidence in support of one party's contention, but also to look at evidence that is contrary to the finding, *Trujillo v. Employment Sec. Dep't*, 105 N.M. 467, 469, 734 P.2d 245, 247 (Ct.App.1987). We "must then decide whether, on balance, the agency's decision was supported by substantial evidence." *Id.*; *see Wing Pawn Shop*, 111 N.M. at 739, 809 P.2d at 653.

III. DISCUSSION

This appeal concerns the application of the Foreign Commerce Clause of the United States Constitution, Article I, Section 8, Clause 3, to New Mexico's statutory system of corporate income tax. The New Mexico corporate income tax statute uses the federal tax code's definition of "net income" with certain adjustments. Like the federal scheme, New Mexico allows corporations to take a deduction for dividends received from domestic subsidiaries, but not from foreign subsidiaries. Unlike the federal scheme, however, New Mexico does not allow a credit for taxes paid to foreign countries.

A. Generally

To provide a context for understanding the various allowable filing methods and their relationship to the Foreign Commerce Clause issues raised by this case, we deem it necessary to review the interrelationship between the Foreign Commerce Clause, the Due Process Clause, and New Mexico's ability to tax income generated in foreign commerce.

It is fundamental under both the Due Process Clause and the Commerce Clause of the United States Constitution that a state may not, when imposing an income-based tax, tax value earned outside of its borders. *See ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 102 S.Ct. 3103, 73 L.Ed.2d 787 (1982). When dealing with income that has been earned by a multistate and multinational taxpayer, determining what income has been earned by that taxpayer within a particular state can be extremely complicated and has generated a significant

amount of constitutional litigation. *See, e.g., Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354, 102 S.Ct. 3128, 73 L.Ed.2d 819 (1982); *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 100 S.Ct. 2109, 65 L.Ed.2d 66 (1980); *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 98 S.Ct. 2340, 57 L.Ed.2d 197 (1978). Because of the difficulty of precisely measuring a state's properly apportioned share of a multijurisdictional taxpayer's income, the United State Supreme Court has long held that the Constitution imposes no single formula on the states, *Wisconsin v. J.C. Penney*, 311 U.S. 435, 444-45, 61 S.Ct. 246, 85 L.Ed. 267 (1940), and has placed upon a taxpayer challenging a state's formula the burden of showing by clear and cogent evidence that a state tax results in the taxation of extraterritorial values. *Container Corp.*, 463 U.S. at 170, 103 S.Ct. at 2942-43 (quoting *Moorman Mfg.*, 437 U.S. at 274, 98 S.Ct. at 2345).

Historically, states attempted to account for their share of taxable income based upon systems of separate accounting, whereby a company's income earned within the geographical boundaries of the state was determined based on formal corporate entities or on an attempt to segregate transactions conducted within the state. This methodology, called separate accounting, has fallen into disfavor because it was subject to manipulation and imprecision and, significantly, either ignored or failed to capture the many subtle and often unquantifiable transfers of value that take place among the components of a

large, complex enterprise. *See generally Mobil Oil*, 445 U.S. at 438-39, 100 S.Ct. at 1232-33.

As a result of the inadequacy of the separate accounting concept, the unitary business concept evolved. The unitary business principle generally disregards territorial boundaries and corporate structure issues. The unitary concept requires viewing a business enterprise as a single unit irrespective of whether the enterprise crosses geographic boundaries or its business is conducted through separate corporate entities. Once the scope of a unitary business is defined, the taxable income of the total unitary enterprise is determined, and an apportionment formula is applied to approximate the unitary business income that is reasonably related to the business' activities conducted within the taxing jurisdiction based upon various objective measures of the taxpayer's activities both within and without the taxing jurisdiction. The Supreme Court long ago upheld the constitutionality of the basic unitary business concept. *See, e.g., Mobil Oil*, 445 U.S. at 439, 100 S.Ct. at 1232-33; *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 51 S.Ct. 385, 75 L.Ed. 879 (1931); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 45 S.Ct. 82, 69 L.Ed. 282 (1924); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 41 S.Ct. 45, 65 L.Ed. 165 (1920). In other words, it is the unitary business principle that provides the constitutional basis for the use of an apportionment formula by the states to apportion to the states their appropriate share of corporate income.

B. Federal Tax Returns

As defined in I.R.C. Section 1501, DuPont filed consolidated federal corporate income tax returns with its affiliated group, which included the taxpayer, for the tax years 1988, 1989, 1990, and 1991. *See* 26 U.S.C. § 1501 (1988). A consolidated return reports the income of a parent corporation and members of its affiliated group. *See id.* DuPont received dividends from both its domestic and foreign subsidiaries during those years. In calculating its federal taxable income in accordance with federal law, DuPont deducted the dividends that the taxpayer received from its domestic subsidiaries, but not the dividends received from its foreign subsidiaries. *See* 26 U.S.C. § 243 (1988).

DuPont, however, claimed a credit against its federal tax liability with respect to taxes that it and its foreign and domestic subsidiaries paid to foreign countries.

C. New Mexico Tax Returns

1. Reporting Methods

The taxpayer and DuPont elected to file separate New Mexico corporate income tax returns for the same years using the "separate-entity reporting" method. This method of reporting, however, is only one of four reporting methods New Mexico allows corporate taxpayers to use when filing their initial New Mexico income tax returns. *See* Regulation CIT 9:2.[5] New Mexico allows

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[5] Regulations issued under the Corporate Income and Franchise Tax Act, NMSA 1978, Sections 7-2A-1 through 7-2A-14 (Repl.Pamp.1993), are prefixed by the letters "CIT."

corporate taxpayers to elect among two versions of separate accounting, the combination of unitary corporations, or the federal consolidated group reporting methods. *Id.*

2. Apportionment of New Mexico Taxable Income

After a taxpayer elects which reporting method it will use, a three-factor apportionment formula is then applied to determine the portion of income subject to New Mexico taxation for corporations having income from both within and without New Mexico. *See* UDITPA §§ 7-4-1 through 7-4-21; *NCR Corp.*, 115 N.M. at 615, 856 P.2d at 985. The UDITPA formula creates three factors: (1) the "property factor," which is the average value of the taxpayer's real and tangible personal property owned or rented in New Mexico (the property numerator) divided by the average value of the taxpayer's real and tangible personal property owned or rented everywhere (the property denominator), Section 7-4-11; (2) the "payroll factor," which is the total amount paid by the taxpayer in New Mexico as compensation (the payroll numerator) divided by the total compensation paid everywhere by the taxpayer (the payroll denominator), Section 7-4-14; and (3) the "sales factor," which is the total sales of the taxpayer in New Mexico (the sales numerator) divided by the total sales of the taxpayer everywhere (the sales denominator), Section 7-4-16. These three factors are added together and divided by three to arrive at a fraction or multiplier. *See* § 7-4-10. This multiplier is applied to the corporation's total apportionable income to arrive

at the portion that can be taxed by New Mexico. *See NCR Corp.*, 115 N.M. at 615, 856 P.2d at 985.

3. Detroit Formula of Factor Relief

Unlike the federal system, New Mexico does not allow a foreign tax credit for corporations using the separate-entity reporting method and having foreign subsidiary dividend income. The New Mexico tax scheme, however, does allow corporations using the separate-entity reporting method and having foreign subsidiary dividends to apply the "Detroit formula of factor relief." *See* Regulation UDI 19:10[6] (issued March 4, 1994, effective retroactively to January 1, 1988).

The Detroit formula of factor relief operates in the following manner. Where dividends from a foreign subsidiary are included in the apportionable tax base of a taxpayer's domestic parent, the UDITPA three-factor apportionment formula is modified by including in the denominators of the parent corporation's property, payroll, and sales factors, a percentage of the property, payroll, and sales of the dividend-generating foreign subsidiary. *See* Regulation UDI 19:10. The percentage of the foreign subsidiaries' property, payroll, and sales included is the ratio that the net dividends received from such subsidiary bears to the subsidiary's net profits, but not to exceed one-hundred percent. *Id.* The overall effect of applying the Detroit formula is to reduce the apportionment factor applied to New Mexico base income.

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[6] Regulations issued under the UDITPA Sections 7-4-1 through 7-4-21, are prefixed by the letters "UDI."

D. Conoco's Refund Claims

The taxpayer based its refund claims and its reduced tax payments on the United States Supreme Court's decision in *Kraft*, which is central to this dispute. That case involved a similar reliance on federal standards for determining taxable income and the use of a similar reporting system, separate-entity reporting. There, the Court held that the Iowa income tax scheme, which treated dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries, facially discriminated against foreign commerce in violation of the foreign commerce clause. *Kraft*, 505 U.S. at 82-83, 112 S.Ct. at 2372.

The taxpayer contends that it is entitled to refunds for the tax years 1988, 1989, 1990, and 1991, on the basis that *Kraft* requires this Court to declare that New Mexico's statutory scheme for taxation of dividend income facially discriminates against foreign commerce in violation of the Commerce Clause of the United States Constitution. *See* U.S. Const. art. I, § 8, cl. 3. The taxpayer thus urges this Court to refund all illegally collected taxes and declare the Department to be without the power to make assessments.

The Department agrees that the separate-entity method of calculating the tax base, if viewed in isolation from the rest of the New Mexico tax scheme, represents discriminatory treatment of foreign subsidiary dividends. The Department argues, however, that United States Supreme Court case law requires this Court to view the interplay of the entire New Mexico tax scheme in assessing a facial discrimination attack. According to the

Department, when viewed as a whole, the New Mexico tax scheme, unlike the Iowa Business Tax on Corporations Act in *Kraft*, offers other filing options and offers the Detroit formula of factor relief. As a result, the Department contends that the New Mexico statute is constitutional. We agree with the Department.

The Commerce Clause of the United States Constitution states that "Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States and with the Indian Tribes." U.S. Const. art. I, § 8, cl. 3. The Commerce Clause restricts the "power of a state to regulate or tax interstate and foreign commerce even in the absence of the enactment of specific congressional legislation." *NCR Corp.*, 115 N.M. at 618, 856 P.2d at 988. For unitary corporations, like the taxpayer, having income derived both within and outside a state, New Mexico, like the majority of states, employs the UDITPA three-factor apportionment formula that averages the percentages of in-state property, payroll, and sales factors. *See* NMSA 1978, § 7-2A-8(A)(1) (Repl.Pamp.1993); §§ 7-4-10 through 7-4-18. The United States Supreme Court has specifically approved this type of apportionment formula. *See, e.g., Container Corp.*, 463 U.S. at 170, 103 S.Ct. at 2942-43. Indeed, the three-factor formula "has become . . . something of a benchmark against which other apportionment formulas are judged." *Id.* (citations omitted).

In analyzing Commerce Clause challenges to tax statutes, a four-part test applies when purely interstate commerce is involved. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326 (1977). A state tax survives a Commerce Clause challenge when the

tax: (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state. *Id.* Where a tax authority seeks to tax foreign commerce, the tax must satisfy the four-part test set out in *Brady*, plus two additional considerations:

> [A] court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments." If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause.

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 451, 99 S.Ct. 1813, 1823, 60 L.Ed.2d 336 (1979). As long as the intra-state and extra-state activities form part of a single, unitary business, the fact that the tax is apportioned in part upon the taxpayer's foreign income sources does not constitute a bar to state taxation. *NCR Corp.*, 115 N.M. at 617, 856 P.2d at 987 (citing *Mobil Oil*, 445 U.S. at 439-40, 100 S.Ct. at 1232-33).

As the Court recognized in *Mobil Oil*, "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil*, 445 U.S. at 439, 100 S.Ct. at 1232-33. As long as dividends from subsidiaries and affiliates of a parent corporation doing business in New Mexico reflect profits derived from a functionally integrated enterprise, those dividends, including foreign subsidiary dividend income, are

income to the parent earned in a unitary business, and New Mexico has the right to impose a corporate income tax on an apportioned share of that unitary income. *NCR Corp.*, 115 N.M. at 619, 856 P.2d at 989.

By following the federal scheme to arrive at net income, both Iowa and New Mexico allow a deduction for dividends received from domestic subsidiaries, but not for those received from foreign subsidiaries. The crux of the problem for purposes of comparing disparate treatment of domestic and foreign dividend income of the parent corporation doing business in Iowa or New Mexico is to focus on how dividends received from both domestic and foreign subsidiaries not doing in-state business are treated. *See, e.g., Kraft*, 505 U.S. at 74 n. 10, 80 n. 23, 112 S.Ct. at 2368 n. 10, 2371 n. 23. In that situation, neither New Mexico under separate entity filing nor Iowa would tax the corporate income of either subsidiary. Both, however, would allow a deduction to the parent corporation for dividends received from its domestic subsidiary corporations, but not for dividends received from its foreign subsidiary corporations. Neither state allows a credit or deduction similar to the federal credit or deduction election for foreign taxes paid to foreign countries on the earnings of the foreign subsidiary. New Mexico, however, unlike Iowa, allows corporate taxpayers to apply the Detroit formula of factor relief as a modification to the UDITPA three-factor formula for those taxpayers using the separate-entity reporting method and having foreign subsidiary dividend income.

Kraft does not mandate the refund of taxes on the basis sought by the taxpayer because there is a significant difference between the taxing systems of Iowa and of

New Mexico. New Mexico has modified its apportionment formula in response to *Kraft* to ensure that the foreign commerce of taxpayers received equal tax treatment with domestic commerce. In March 1994, the Department adopted Regulation UDI 19:10, applicable retroactively to tax years beginning in 1988. This regulation allows taxpayers to adjust the standard apportionment formula through the inclusion of a portion of the factors of the taxpayer's foreign subsidiaries, thereby reducing the percentage of the apportionable base subject to tax in New Mexico. With this modification, a taxpayer's foreign commerce is subject to comparable formulary apportionment applicable to the taxpayer's domestic commerce. *Kraft* requires only that states treat foreign and domestic commerce equally; it does not require that states go beyond that equality, to create a potential of a windfall for taxpayers.

In this case, we believe the taxpayer is entitled to a refund only if the New Mexico tax scheme as a whole is unconstitutional and only if the sole appropriate way to remedy the discriminatory treatment of foreign subsidiary dividend income is by allowing the taxpayer to totally exclude all foreign subsidiary dividend income from the tax base in arriving at the "net income" to be taxed by apportionment in New Mexico. Because the taxpayer did not satisfy its initial burden of proving that the New Mexico tax scheme facially discriminates against foreign commerce, we decline to reach the taxpayer's remedy analysis. *See NCR Corp.*, 115 N.M. at 620, 856 P.2d at 990.

The taxpayer advocates that we focus exclusively on the "unconstitutional tax base" under the Corporate

Income and Franchise Tax Act, Sections 7-2A-1 through 7-2A-14. It urges us to declare New Mexico's treatment of foreign subsidiary dividend income unconstitutional and to hold that the only way to remedy the discriminatory tax treatment of domestic and foreign subsidiary dividend income for separate-entity filers is to "equalize" their treatment in the calculation of the tax base by either excluding both and refunding taxes or including both and assessing back taxes. Without legislation mandating a tax on domestic dividend income, the taxpayer continues, the only practical remedy is to refund taxes to taxpayers filing separate-entity returns based on an exclusion of foreign subsidiary dividend income as well as domestic subsidiary dividend income from their tax base calculations.

We conclude that the taxpayer's suggested approach, in spite of having the benefit of simplicity, does not comport with the reality of the New Mexico tax scheme and applicable law. Even a cursory look at the relevant statutes demonstrates that none of them can either be read or applied without the others. *See* Tax Administration Act, NMSA 1978, §§ 7-1-1 through 7-1-82 (Repl.Pamp.1993); §§ 7-2A-1 through 7-2A-14; §§ 7-4-1 through 7-4-21. For example, the Tax Administration Act, which provides certain procedures related to the fair administration of taxes (procedures for notice, assessments, refunds, hearings, and of protests) expressly states that the Tax Administration Act applies to and governs the "Corporate Income and Franchise Tax Act [Sections 7-2A-1 through 7-2A-14]," and the "Uniform Division of Income for Tax Purposes Act [Sections 7-4-1 through 7-4-21]." Sections 7-1-2(A)(17), (18). Section 7-2A-2(R),

defines "unitary corporations," and Section 7-2A-8(A)(1) provides that any taxpayer having income that is taxable both within and without New Mexico shall allocate and apportion their income as provided in Sections 7-4-1 through 7-4-21.

Additionally, the United States Supreme Court has held that it is proper to look at the entire tax scheme in evaluating a claim of discrimination. *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 69, 83 S.Ct. 1201, 1203-04, 10 L.Ed.2d 202 (1963); *see also West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 200-01, 114 S.Ct. 2205, 2215, 129 L.Ed.2d 157 (1994) (determination of discrimination under the Commerce Clause requires an analysis of the "purposes and effects" of the state's taxing system as a whole). The proper focus, therefore, is on the New Mexico tax scheme as a whole. When viewed as a whole, the New Mexico tax scheme, unlike the Iowa statute at issue in *Kraft*, provides taxpayers with other filing options and allows those taxpayers electing the separate-entity filing method and having foreign subsidiary dividend income to apply the Detroit formula of factor relief to its tax base calculated on the separate-entity method. This allowance was promulgated by the Department under Section 7-4-19.

The taxpayer, citing *State ex rel. McCulloch v. Ashby*, 73 N.M. 267, 387 P.2d 588 (1963), contends that a facially discriminatory statute cannot be remedied by an administrative regulation. In *Ashby*, however, the regulation that was alleged to save the statute was not authorized by the statute. *Id.* at 271, 387 P.2d at 590. In this case, on the other hand, the regulation permitting use of the Detroit

formula was enacted pursuant to the express statutory authority of Section 7-4-19.

The taxpayer next argues that Section 7-4-19 does not permit the Department to promulgate a regulation addressing differential treatment of foreign and domestic source-dividend income. Section 7-4-19 permits the Department to require taxpayers to use allocation and apportionment methods other than contained in UDITPA if "the allocation and apportionment provisions of . . . [UDITPA] do not fairly represent the extent of the taxpayer's business activities in this state." Because the taxpayer vigorously argues that this is not a "fair allocation" or "fair apportionment" case, but rather a "facially discriminatory tax base" case, the taxpayer contends that regulations under Section 7-4-19 are unavailing. We disagree.

The purpose of fair apportionment is to insure that a given taxing jurisdiction does not tax extrajurisdictional income. *See Exxon*, 447 U.S. at 223-30, 100 S.Ct. at 2120-24. As we noted previously, the use of certain accounting methods and corporate formalities can result in manipulation and understatement of income to the taxing jurisdiction. The use of UDITPA thus serves two purposes at once. At the same time that it insures that only income with a nexus to the taxing jurisdiction is taxed, it also insures that all income that can be legitimately taxed is taxed. Although apportionment does not always accomplish its purposes with exact and empirical precision, *see Mobil Oil*, 445 U.S. at 452, 100 S.Ct. at 1239 (Stevens, J., dissenting), that fact does not detract from its dual purposes. Thus, if a regulation based on these purposes

serves to eliminate what would otherwise be a discrimination, we should not ignore it.

We turn now to the consideration of (1) the applicability of the other filing options to this case, and (2) whether the New Mexico tax scheme (including the availability of the Detroit formula of factor relief for those taxpayers using the separate-entity reporting method and having foreign subsidiary dividend income) withstands the taxpayer's facial discrimination attack.

1. Alternative Methods of Calculating the Tax Base

Initially, we address the Department's argument that the taxpayer should be estopped from challenging the discriminatory treatment of foreign subsidiary dividend income when New Mexico allows corporations to elect its method of calculating its tax base and offers alternative methods of filing returns. The Department contends that the taxpayer benefitted from significantly lower taxes as a result of electing the separate-entity method of calculating its tax base, and, thus, should not now cry "foul" in order to get even lower taxes for the applicable tax years by excluding all foreign subsidiary dividend income from its tax base calculations. We consider the Department's suggested analysis problematic and decline to endorse it.

As the taxpayer points out, and the Department admits in its answer brief, the Department did not cross-appeal this issue. We conclude, however, that the Department may raise this issue for review, without taking a cross-appeal, as another ground for affirming the hearing officer's decision in the event that this Court were to

consider reversal in whole or in part. *See* SCRA 12-201(C) (review without cross-appeal); *Frederick v. Younger Van Lines*, 74 N.M. 320, 328, 393 P.2d 438, 443 (1964); *see also Jaramillo v. Jaramillo*, 113 N.M. 57, 62, 823 P.2d 299, 304 (1992) (lower court's decision will be affirmed on review if that decision was correct, even though court may have used an incorrect rationale in arriving at its result).

Nevertheless, on the merits, we agree with the taxpayer that the hearing officer was correct in its determination against the Department, although for different reasons. The hearing officer relied on provisions of Regulation CIT 9:2, which, although permitting a taxpayer to choose any one of four methods of reporting, expressly prohibited any taxpayer from making a retroactive election of a different method once one of the four methods was chosen. The hearing officer also relied on Section 7-1-60, which estops the Department from taking action adverse to a taxpayer who acts in reliance of a regulation.

The Department responds that these provisions of the law are inapposite because the Department was not seeking to make the taxpayer retroactively file under a different reporting method that would require it to pay more taxes. The Department's contention is that, because there was an alternative and presumably constitutional method of filing available to the taxpayer, the taxpayer should not be heard to complain about a method it chose itself. We reject the Department's contention because our Court, as well as other courts, have frequently considered issues arising from a person's choice of one form of government-imposed condition or situation even though other more onerous conditions were available. *See, e.g., Campbell v. Wood*, 18 F.3d 662, 680 (9th Cir.) (en banc)

(court recognizes that it reviews constitutionality of probation conditions although probationer could have chosen incarceration, in which case dispute about probation conditions would not have arisen), *cert. denied*, 511 U.S. 1119, 114 S.Ct. 2125, 128 L.Ed.2d 682 (1994); *State v. Charlton*, 115 N.M. 35, 37-38, 846 P.2d 341, 343-44 (Ct.App.1992) (court reviews banishment as apparent condition of probation or suspended sentence), *cert. denied*, 114 N.M. 577, 844 P.2d 827 (1993). Consequently, we affirm the hearing officer's determination that the taxpayer was not estopped from challenging the separate-entity reporting method on the ground that alternative methods of filing exist.

2. The Detroit Formula of Factor Relief

The taxpayer argues that the facially discriminatory features of Sections 7-2A-1 through 7-2A-14, cannot be corrected by attempting to more fairly apportion a "constitutionally defective tax base" by application of the Detroit formula of factor relief to it. We disagree.

As we noted above, the taxpayer incorrectly views the separate-entity method of calculating the tax base in a vacuum, without considering the entire New Mexico tax scheme. This is contrary to the manner under which the New Mexico tax scheme operates and contrary to existing United States Supreme Court law. The taxpayer's analysis also ignores the purpose of factor representation, which is to fairly apportion the total income of a unitary, multistate corporation to each state to accurately determine the income generated in a state that is subject to that state's tax. *See Exxon*, 447 U.S. at 223-30, 100 S.Ct. at 2120-23.

The Due Process Clause and the Commerce Clause do not prohibit states from including foreign-source dividends in the apportionable tax base. *See Mobil Oil; NCR Corp.* Under the Detroit formula of factor relief, where dividends from a foreign subsidiary are included in the apportionable tax base of a domestic parent corporation, a certain percentage of the foreign subsidiaries' property, payroll, and sales factors are also included in the denominator of the parent corporation. The percentage of foreign factors included in the parent's denominators is equal to the percentage of the foreign subsidiaries' earnings paid to the parent as dividends. The Department provided expert testimony that the inclusion of the factors that generated the foreign subsidiary dividends resulted in New Mexico taxing only income earned within its borders and, in doing so, theoretically excluded foreign dividends from the tax base. We believe that the Commerce Clause and Due Process Clause are satisfied by application of the Detroit formula when foreign subsidiary dividend income is included in the tax base. *See Tambrands, Inc. v. Maine Tax Assessor,* 595 A.2d 1039 (Me.1991).

Although the taxpayer provided evidence that application of the Detroit formula to its returns for tax years 1988, 1989, 1990 and 1991, resulted in higher taxes than the exclusion of dividends from the tax base, the taxpayer did not offer evidence to counter the Department's evidence that equal, higher, or lower New Mexico taxes resulted from application of the Detroit formula based on the relative *efficiencies* of the taxpayer's domestic and foreign operations, and not upon the foreign or domestic *source* of the taxpayer's income. The taxpayer contends

that the hearing officer erroneously relied on the Department's experts because those experts based their opinions on "unsupported assumptions" and "mere possibilities" with the result that their opinions were incompetent and insufficient to support any findings. We note that neither the written record of the tape log nor the taxpayer's appellate briefs indicates that the taxpayer had any objection to the testimony of the Department's experts on competency grounds. It is the general rule that the admission of expert testimony and the weight to be given such testimony is for the trial court to determine. *See Sanchez v. Molycorp, Inc.*, 103 N.M. 148, 153, 703 P.2d 925, 930 (Ct.App.1985). In this case, the hearing officer found the Department's experts' opinions to be adequately explained and more persuasive on the issues than the taxpayer's experts' opinions. Based on the theoretical nature of the Department's experts' testimony, and considering the sense made in the concrete examples used by the hearing officer in his decision, we hold that his determination to accept the Department's experts' opinions was not erroneous.

Thus, the taxpayer failed to prove by clear and cogent evidence that the income attributed to New Mexico was in fact out of all appropriate proportions to the business transacted in the state or has led to a grossly distorted result. *See Container Corp.*, 463 U.S. at 170, 103 S.Ct. at 2942-43. Thus, too the taxpayer has failed to show that New Mexico's system of corporate income taxation, which applies the Detroit formula of factor relief to separate-entity reporting contemporaneously with the UDITPA formula, impermissibly discriminates against foreign commerce under all sets of circumstances. The

United State Supreme Court's decision in *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 398-99, 104 S.Ct. 1856, 1862-63, 80 L.Ed.2d 388 (1984), on which the taxpayer relies for the proposition that "fair apportionment" and "nondiscrimination" are not synonymous, does not persuade us otherwise. We agree that these terms are not synonymous. Discrimination, however, was clearly shown to exist in *Westinghouse*; the same cannot be said in this case. Additionally, nothing in *Westinghouse*, or in any other case cited by the taxpayer or discovered by our own research, indicates that fair apportionment can never operate to cure discrimination. In this case, we believe, the evidence indicated that it did.

We therefore hold that the taxpayer failed to meet its burden required to challenge on facial discrimination grounds the New Mexico tax scheme in a situation where the burden of proof is on the taxpayer. *See United States v. Salerno*, 481 U.S. 739, 745, 107 S.Ct. 2095, 2100, 95 L.Ed.2d 697 (1987) (an attack of facial discrimination requires the claimant to show that no set of circumstances exists under which the act would be valid); *NCR Corp.*, 115 N.M. at 620, 856 P.2d at 990 (the burden is on the taxpaying corporation to show by "clear and cogent evidence" that the income attributed to the state is in fact disproportionate to the business transacted in that state); *see also Tipperary Corp. v. New Mexico Bureau of Revenue*, 93 N.M. 22, 24, 595 P.2d 1212, 1214 (Ct.App.) (taxpayer has duty to present evidence overcoming correctness of assessment), *cert. denied*, 92 N.M. 675, 593 P.2d 1078 (1979). To the extent that our analysis differs from that of the hearing officer, this Court will affirm if the ruling appealed from is right for any reason. *See State v. Lovato*, 112 N.M. 517,

521, 817 P.2d 251, 255 (Ct.App.), *cert. denied*, 112 N.M. 388, 815 P.2d 1178 (1991); *see also Jaramillo*, 113 N.M. at 62, 823 P.2d at 304. We thus affirm the hearing officer's denial of the taxpayer's refund claims for the tax years 1988, 1989, 1990, and 1991.

E. The Assessment

The hearing officer partially upheld and partially denied the Department's assessment of taxes, penalties, and interest for tax year 1991. In Assessment No. 1,638,288, the Department did not calculate the taxpayer's tax liability using the Detroit formula. As a result, the hearing officer ordered the Department to abate that portion of the assessed tax and interest in excess of the amount of tax and interest owing if the Detroit formula were applied. The hearing officer then struck down the penalty on Assessment No. 1,638,288 because the taxpayer was not negligent in calculating its tax base for the tax year 1991, by excluding foreign dividends based on the judgment of its tax manager and accountant. We conclude that the hearing officer's findings on this issue were supported by substantial evidence in the record and that his conclusions were in accordance with applicable law. We therefore affirm on this issue.

IV. CONCLUSION

We hold that the hearing officer properly denied the taxpayer's claims for refunds. We also hold that the hearing officer properly reduced the Department's assessment against the taxpayer. We thus affirm.

IT IS SO ORDERED.

PICKARD, J., concurs.

DONNELLY, J., dissents and files opinion.

DONNELLY, Judge (dissenting).

I respectfully dissent. I would reverse the administrative hearing officer's decision that upheld the State Taxation and Revenue Department's denial of Taxpayer's refund claims for the 1988, 1989, and 1990 tax years and affirmed the imposition of additional taxes and penalties against Taxpayer for the 1991 tax year.

The Department concedes that New Mexico's corporate income tax statute, as it applies to the separate entity method of reporting, is similar to Iowa's corporate income tax scheme that was declared invalid by the United States Supreme Court in *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71, 112 S.Ct. 2365, 120 L.Ed.2d 59 (1992). *Kraft* held that Iowa's tax reporting and payment provisions, as applied to corporations engaged in domestic and foreign commerce, facially discriminated against foreign commerce because they treated dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries and such disparate tax treatment is inconsistent with the Foreign Commerce Clause of the United States Constitution. *Id.*

The separate entity method of reporting under our Corporate Income and Franchise Tax Act also results in the same disparate tax treatment of foreign subsidiary dividends condemned in *Kraft*. Unlike the federal corporate income tax law, New Mexico's corporate taxing

scheme, like Iowa's, does not authorize a credit or deduction for foreign taxes paid to foreign countries on the earnings of a corporation's foreign subsidiaries. Similarly, New Mexico and Iowa both allow a deduction for dividends received from domestic subsidiaries but not those derived from a taxpayer's foreign subsidiaries. As a result, both schemes include foreign, but not domestic, subsidiary dividend income in the tax bases used to determine the amount of a corporation's state income taxation.

Although acknowledging the similarity of New Mexico's corporate income tax to that of Iowa's, the Department points out that following the decision in *Kraft*, New Mexico modified its tax scheme by adopting Administrative Regulation UDI 19:10 (issued March 4, 1994, effective retroactively to tax years beginning on or after January 1, 1988),[1] allowing unitary corporations like Taxpayer, who use the separate entity method of reporting for New Mexico corporate income taxes, to adjust the Uniform Division of Income for Tax Purposes Act (UDITPA) three-

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[1] In pertinent part, Regulation UDI 19:10(A) provides:

> Any corporation that receives foreign-source dividends during the taxpayer's taxable year and that reports its corporate income tax liability to the state as a separate corporate entity and not as a member of a corporate group . . . may adjust the denominators of its apportionment factors for foreign source dividends received. The taxpayer may increase the denominator of each of its apportionment factors by an amount equal to the respective denominator of the payor stated in United States dollars times a ratio of foreign-source dividends paid to the taxpayer divided by the book income of the payor.

factor apportionment formula by applying a modified version of the "Detroit formula of factor relief." *See* NMSA 1978, §§ 7-4-1 to -21 (Repl.Pamp.1993). Consequently, the Department asserts that New Mexico's tax scheme, when viewed as a whole, removes its corporate income tax scheme from the constitutional problems identified in *Kraft*.

In my opinion, the Department's effort to divorce itself from the holding in *Kraft* fails. My disagreement with the analysis and decision of the majority turns on its application of the four-part test articulated in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326 (1977), and the two additional inquiries imposed by *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451, 99 S.Ct. 1813, 1823, 60 L.Ed.2d 336 (1979), when the tax involves foreign commerce.[2] In order to surmount a challenge to the constitutionality of a state tax under the Commerce Clause of the United States Constitution, the Department must show that the tax (1) has been applied based upon an activity of taxpayer having a substantial nexus within the taxing state, (2) has been fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state. *Complete Auto Transit*, 430 U.S. at 279, 97 S.Ct. at 1079. Since the tax here involves foreign commerce, *Japan Line, Ltd.* also requires a showing

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[2] Taxpayer owns either all of the stock or varying percentages of stock in over 100 corporate subsidiaries that are incorporated and operate in foreign countries. Taxpayer receives dividends from these subsidiaries paid from the subsidiary corporations' after-tax earnings.

that, notwithstanding the fact that the tax satisfies the other criteria, it does not create a substantial risk of international multiple taxation, and that the state tax will not prevent "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.' " *Japan Line, Ltd.*, 441 U.S. at 451, 99 S.Ct. at 1823.

The Department contends that the use of the Detroit formula modifies the UDITPA formula so as to more accurately apportion the amount of this state's income that a parent corporation is found to have incurred because the Detroit factor adjusts the UDITPA formula by adding to the denominator of the UDITPA formula the amount of property, payroll, and sales of any dividend income-generating foreign corporate subsidiary. However, modification of an apportionment formula to reduce the tax on Taxpayer's foreign subsidiaries does not eliminate the disparate treatment of Taxpayer proscribed by *Kraft*.

The regulation relied upon by the Department which authorizes the use of the Detroit formula of factor relief does not remedy the main challenge of Taxpayer in the instant case. This Court, in *NCR Corp. v. Taxation & Revenue Department*, 115 N.M. 612, 618, 856 P.2d 982, 988 (Ct.App.), *cert. denied*, 115 N.M. 677, 857 P.2d 788 (1993), and *cert. denied*, 512 U.S. 1245, 114 S.Ct. 2763, 129 L.Ed.2d 877 (1994), upheld the right of the state to impose a fairly apportioned corporate income tax upon NCR (a unitary corporation) having income derived both within and outside the state, including its foreign subsidiaries. This

Court in *NCR*, however, did not address the issue presented here, namely, whether the state's unequal treatment of foreign subsidiary dividend as compared to domestic subsidiary dividend income violates the Foreign Commerce Clause of the United States Constitution.

Because the tax involved here permits corporations with domestic subsidiaries to exclude from the tax base the dividend income of those subsidiaries, but requires Taxpayer, who receives dividend income from foreign subsidiaries, to include such income in its tax base, without allowing a credit or a deduction, the tax does not accord equal treatment and thus is facially discriminatory. The Department has not shown that Taxpayer here is accorded equal treatment with corporations engaged in interstate commerce and which have no foreign subsidiary dividend income.[3] Nor has the Department shown any compelling state interest which justifies disparate tax treatment of corporate foreign and domestic dividend income.

Regulation UDI 19:10 does not cure the facial discrimination recognized in *Kraft*, because it fails to eliminate the unequal treatment of foreign and domestic subsidiary dividend income from Taxpayer's tax base. When foreign subsidiary dividend income is included in a corporation's tax base, the Detroit formula serves to

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[3] In this appeal, the administrative hearing officer found that Taxpayer's foreign subsidiaries operate in foreign countries and the flow of value between Taxpayer and its foreign subsidiaries, including the dividends and deemed dividends received from its foreign subsidiaries, constitute foreign commerce.

increase the denominator of the UDITPA apportionment formula by the amount of the foreign subsidiary property, payroll, and sales without also increasing the numerator. This results in a diminution of the apportionment formula and presumably lessens the taxpayer's tax liability. However, the Detroit formula does not remove the foreign subsidiary dividend income from Taxpayer's tax base. Thus, Taxpayer's total foreign subsidiary dividend income remains subject to taxation under the Department's regulation. Consequently, Regulation UDI 19:10, which employs the Detroit formula, falls well short of the " 'strict rule of equality' " required in interstate commerce clause cases. *See Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 649, 114 S.Ct. 1815, 1821, 128 L.Ed.2d 639 (1994) (quoting *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 73, 83 S.Ct. 1201, 1205-06, 10 L.Ed.2d 202 (1963)); *see also Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 101, 113 S.Ct. 2510, 2520, 125 L.Ed.2d 74 (1993) (remedies employed by state must totally eliminate discrimination).

Furthermore, although the Department argues that application of the Detroit formula of factor relief provides a fair method of apportionment, this argument addresses only a portion of the six-part test to be applied. Fairness in applying the method of apportionment relates to the second factor in the *Complete Auto Transit* test – it does not satisfy the other components of the test. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, ___ U.S. ___, 115 S.Ct. 1331, 131 L.Ed.2d 261 (1995) (refusing to address a fair apportionment argument in determining whether a state-imposed tax violates interstate Commerce Clause); *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 399, 104 S.Ct.

1856, 1863, 80 L.Ed.2d 388 (1984) (" 'Fairly apportioned' and 'nondiscriminatory' are *not* synonymous terms." (emphasis added)).

Since, as pointed out by Taxpayer here, New Mexico continues to require that Taxpayer's foreign dividend income derived from its foreign subsidiaries be included in its tax base and this requirement does not apply to corporations with domestic subsidiaries, a disparity exists, treating corporations who receive dividend income from foreign subsidiaries less favorably. It is this difference, I believe, that fails to remove Taxpayer's Commerce Clause challenge in the present case from the constitutional impediments recognized in *Kraft*. Specifically, the tax in question here, as applied to Taxpayer, does not satisfy the third component of the *Complete Auto Transit* test, or the requirement in *Japan Line, Inc.*, that such tax will not create a substantial risk of multiple, international taxation.

The Department also contends, and the administrative hearing officer below agreed, that under *United States v. Salerno*, 481 U.S. 739, 745, 107 S.Ct. 2095, 2100, 95 L.Ed.2d 697 (1987), Taxpayer failed in its burden to establish that under no set of circumstances would application of this state's taxing scheme be valid. I believe the Department and the administrative hearing officer erroneously transferred the burden to Taxpayer to show that the Detroit formula of factor relief discriminates against foreign commerce. Taxpayer offered evidence that while application of the Detroit formula reduces, in part, the tax on its foreign subsidiary dividends, nevertheless, this

formula does not eliminate this state's unequal tax treatment of such income.[4] This evidence was sufficient to rebut the presumption of the correctness of the tax, hence, the burden shifted to the Department to establish that this state's corporate income tax scheme satisfies each factor of the four-part test of *Complete Auto Transit* and the two additional factors set out in *Japan Line, Ltd.*

Simply stated, Taxpayer's challenge here is that the tax base used by New Mexico to compute corporate income taxes under the separate entity accounting method impermissibly violates the Foreign Commerce Clause of the United States Constitution by requiring foreign subsidiary dividend income to be included in Taxpayer's taxable income, while excluding domestic subsidiary dividend income. This challenge is supported by persuasive authority. *See Kraft*, 505 U.S. at 78-82, 112 S.Ct. at 2370-71 (inclusion of dividend income of foreign subsidiaries of domestic corporation that is not required of domestic subsidiaries, facially discriminates between domestic and foreign subsidiaries); *see also Woosley v. California*, 3 Cal.4th 758, 13 Cal.Rptr.2d 30, 35-36, 838 P.2d 758, 771 (1992) (en banc) (tax imposed at uniform rate on

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[4] As recognized in *Kraft*, legitimate business reasons often lead a corporation to conduct foreign business through incorporation of foreign subsidiaries. *Kraft*, 505 U.S. at 76 n. 15, 112 S.Ct. at 2369 n. 15. Yet, as acknowledged by the Department, whether a taxpayer that excludes foreign dividends from the tax base would pay less tax or more tax than a taxpayer using Regulation UDI 19:10 depends on the economic efficiency of the foreign operations. Thus, if the economic efficiency of Taxpayer's foreign operations exceeds that of its domestic operations, Taxpayer's New Mexico income tax is increased.

intrastate and interstate commerce may still be facially discriminatory if state law defines the tax base differently for interstate as opposed to intrastate transactions), *cert. denied*, 508 U.S. 940, 113 S.Ct. 2416, 124 L.Ed.2d 639 (1993).

In *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 40-41, 110 S.Ct. 2238, 2252-53, 110 L.Ed.2d 17 (1990), the Court suggested that, in order to avoid discriminatory tax treatments, a state may either exclude dividend income derived from a corporation's foreign subsidiaries from taxation or tax such income in the same manner as the Department taxes corporate taxpayers deriving income from domestic subsidiaries within the United States. The Detroit formula of factor relief relied upon by the Department does not follow either approach.

In sum, because the regulation promulgated by the Department includes in the tax base a portion of Taxpayer's income not imposed upon corporations having income from domestic subsidiaries and imposes a tax upon a portion of its foreign subsidiary income, application of the Detroit formula does not meet the requirements of the Commerce Clause and the tax as applied to Taxpayer for the years in question facially discriminates against foreign commerce. I would grant the refunds sought by Taxpayer and invalidate the penalty assessments levied by the Department.

APPENDIX C

IN THE COURT OF APPEALS OF THE STATE OF NEW MEXICO

INTEL CORPORATION,

Plaintiff-Appellant/Cross-Appellee,

vs. No. 15,823

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,

Defendant-Appellee/Cross-Appellant.

APPEAL FROM THE NEW MEXICO TAXATION AND REVENUE DEPARTMENT
GERALD B. RICHARDSON, Hearing Officer

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MEMORANDUM OPINION

(Filed June 30, 1995)

HARTZ, Judge.

Intel Corporation appeals the decision of the New Mexico Taxation and Revenue Department hearing officer denying its claim for refund of New Mexico corporate income tax payments for the tax years 1988 through 1991. The Department cross-appeals from the hearing officer's allowance of Intel's claim to a tax credit for payments for employee child care in the tax year 1991. We affirm the decision of the hearing officer. Only our discussion of the child care credit merits publication.

I. INTEL'S APPEAL

The issue raised by Intel's appeal is identical to the issue recently decided by this Court in *Conoco, Inc. v. Taxation & Revenue Department*, No. 15,372, slip op. (N.M. Ct. App. May 1, 1995). Although we harbor some reservations about the analysis in *Conoco** and believe that the

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* See *Conoco* (Donnelly, J., dissenting). We note that the Department acknowledges, "Whether a taxpayer excluding foreign dividends from the tax base would pay less tax or more tax than a taxpayer using UDI 19:10 depends entirely on the economic efficiency (profits as a function of amount of factors) of the overseas operations." In particular, using UDI 19:10 instead of excluding foreign dividends from the tax base imposes an additional income tax burden on corporations whose overseas operations (conducted by foreign subsidiaries) are more efficient than domestic operations. On the assumption that a corporation will try to invest its capital where it can be utilized most efficiently, it appears that the use of UDI 19:10 will penalize and discourage the foreign investment that a

matter is worthy of review by our Supreme Court, we follow *Conoco* in this case and affirm the decision of the hearing officer.

II. DEPARTMENT'S CROSS-APPEAL

The Department contends that the hearing officer erred in allowing Intel a tax credit under NMSA 1978, Section 7-2A-14(A) (Repl. Pamp. 1993), which states:

> A taxpayer that pays for child care services in New Mexico for dependent children of an employee of the taxpayer during the employee's hours of employment may claim a credit against the corporate income tax imposed pursuant to the Corporate Income and Franchise Tax Act in an amount equal to thirty percent of the total expenses for child care services incurred and paid by the taxpayer in the taxable year.

The credit is limited to $30,000 per taxable year. Section 7-2A-14(D). What makes the provision particularly generous is that the same expenditure by the corporation will usually result in a New Mexico income tax deduction as well as the tax credit. Corporate expenses that are deductible for federal income tax purposes – for example, ordinary and necessary business expenses, I.R.C. § 162(a) – are, with a few enumerated exceptions, also deductible

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corporation would otherwise wish to make. Although one could say that this penalty will be offset by an incentive (provided by the use of UDI 19:10) for corporations to invest capital in foreign operations that are less efficient than domestic operations, it is not clear to us that this incentive constitutes a sufficient offset to satisfy the constitutional prohibitions against burdening foreign commerce.

for New Mexico income tax purposes. Deductibility under state law is a consequence of the state tax being imposed upon "net income," NMSA 1978, Section 7-2A-3(A) (Repl. Pamp. 1993), which is defined in terms of federal taxable income, *see* Section 7-2A-2(C) (Repl. Pamp. 1993) (defining "base income" as federal taxable income) and (I) (defining "net income" as "base income" adjusted for certain enumerated exclusions).[1] No provision of New Mexico law specifically prohibits a corporation from claiming a credit under Section 7-2A-14 for expenditures that are also deductible under federal (and hence state) income tax law.

The credits challenged by the Department were based on payments pursuant to Intel's dependent care assistance program (the DCAP Plan). The hearing officer described the plan as follows:

> The DCAP Plan has two parts. One part is a resource and referral service to assist employees in finding day care programs for their dependent children. The other part is a salary reduction payroll program by which employees may shelter from income tax a portion of their salary and then use the tax sheltered salary to pay for dependent care expenses.
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> Enrollment in the DCAP plan is voluntary by Intel employees. Intel employees may enroll in the DCAP Plan on an annual basis. Upon enrollment, an employee must designate, within certain limitations, a specific amount of salary to be paid into the DCAP Plan. The designated

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[1] The Department has conceded that the payments at issue were deductible.

> amount cannot be changed except in very limited circumstances. Intel pays the designated salary into the plan, rather than to the employee. . . . After incurring dependent care expenses, the employee submits evidence of those expenses to the DCAP Plan and obtains reimbursement of those expenses from the DCAP Plan in accordance with the terms of the DCAP Plan.
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> Any funds placed in the DCAP Plan by Intel on behalf of a participating employee which are in excess of the reimbursed expenses received by the employee during the plan year remain the funds of the DCAP Plan.

The chief advantage to an employee from enrolling in the DCAP Plan is that I.R.C. Section 129 excludes payments into the plan from the employee's gross income for federal income tax purposes, and hence for state income tax purposes. *See* NMSA 1978, § 7-2-3 (Repl. Pamp. 1993) (personal income tax imposed upon "net income"). NMSA 1978, § 7-2-2(N) (Repl. Pamp. 1993) ("net income" defined as "base income" adjusted for certain enumerated exclusions), § 7-2-2(B), ("base income" defined in terms of adjusted gross income for federal income tax purposes).

The Department limits its challenge to credits arising from the salary-reduction component of the plan. The Department allowed the credit claimed by Intel that arise from the referral-service component.

The determinative issue on this appeal is whether the expenses for child care were "incurred and paid" by Intel, within the meaning of Section 7-2A-14(A). The briefs of the parties focus on the meaning of the word "incurred."

One possibility is that "incurred" is used as a term of art that applies only to accrual basis taxpayers. When tax statutes use the phrase "paid or incurred," often the word "paid" is to be applied to cash basis taxpayers and "incurred" is to be applied to accrual basis taxpayers. *See Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 574 (1977). We must reject such a technical application of the words "incurred" and "paid" however, because it would lead to an absurd construction of Section 7-2A-14(A). *See State v. Gutierrez*, 115 N.M. 551, 552, 854 P.2d 878, 879 (Ct. App.) (statute may not be interpreted to reach absurd result), *cert. denied*, 115 N.M. 79, 847 P.2d 313 (1993). The section requires that the expense must be "incurred *and* paid." Because a corporation cannot be both an accrual basis taxpayer and a cash basis taxpayer with respect to the same transaction, *see generally* I.R.C Section 446, adoption of the technical construction of the phrase would mean that no corporation could ever qualify for the tax credit.

We have looked for some special meaning of the phrase "incurred and paid" but without success. Various states have enacted statutes which include the phrase, but apparently no reported decision has construed the language. Thus, in the absence of any reason to do otherwise, we adopt the ordinary meaning of the words. *See Davis v. Commissioner of Revenue*, 83 N.M. 152, 153, 489 P.2d 660, 661 (Ct. App.), *cert. denied*, 83 N.M. 151, 489 P.2d 659 (1971). "Paid" presents no difficulty. As for "incurred," the Department has cited one dictionary as defining the verb "incur" as "[to] bring down upon oneself." *Webster's Third New International Dictionary* 1146

(1971). Another definition is: "[to] become liable or subject to." *Id.* In the present context, we believe the natural definition of "incurred" would be "due because services have been performed." In other words, the addition of "incurred and" to the word "paid" in Section 7-2A-14(A) is simply to prevent the award of credits for prepayment of services to be provided in the future. An expense is "incurred and paid" when it is paid to cover a liability for services already rendered.

The real question before us is not whether expenses for child care were "incurred and paid." It is *who* incurred and paid the expenses. The positions of both parties have considerable force. Intel can properly point out that the money came out of its pocket and it had an obligation to pay the child care expenses. In addition, Intel bore the administrative expenses of the DCAP Plan. On the other hand, the Department can point out that the employee was the true source of the money, because the employee was giving up a portion of his or her salary to enable Intel to make the payment.

We resolve the dispute by considering the context – the entire statutory scheme governing the tax treatment of child care expenditures. Because New Mexico's income tax laws incorporate the pertinent provisions of federal law, we examine both the federal and state provisions. That examination compels us to reject the Department's argument. To adopt the premise that the money involved here was really the employees' and not Intel's would be to contradict the provisions of I.R.C. Section 129. That section states that Intel's payments of child care expenses for an employee are to be excluded from the employee's gross income for federal income tax purposes. In other

words, for income tax purposes the money spent for child care is not considered to be the employee's money. Indeed, I.R.C. Section 129(e)(7) provides that an employee cannot claim any federal income tax deduction or credit (including the credit for child care expenditures) for amounts excluded from the employee's income by Section 129.

Our interpretation does not appear to undermine any policy of the New Mexico tax law. In particular, we reject the Department's implicit suggestion that the legislature would not have condoned such a loss in tax revenue. A similar loss would be incurred under the Department's approach of treating the child care expenses as being paid and incurred by the employee. If expenditures for child care under the DCAP Plan should be treated as expenditures by the employees, then the employees would be entitled to the New Mexico income tax credit for child-care expenses provided by NMSA 1978, Section 7-2-18.1 (Repl. Pamp. 1993). Given the $30,000 cap on the corporate child-care credit, *see* Section 7-2A-14(D), and the large number of Intel employees, the loss to the state in tax revenues might well be granter if one were to treat the expenditures as being the employees', as suggested by the Department. We have no way of knowing what the impact on revenue would be if the Department's approach were applied to all Section 129 plans instituted by corporations in the state.

We recognize and appreciate the Department's concern about what appears to be overly generous income tax treatment of Intel's DCAP Plan. Our task, however, is to interpret the statute as written, not to "improve upon" the work of the legislature. Any modification to the law

sought by the Department must come from the other branches of government.

III. ATTORNEY FEES

Under NMSA 1978, Section 7-1-25(D) (Repl. Pamp. 1993), a taxpayer is entitled to reasonable attorney's fees if we affirm a decision by the hearing officer that has been appealed by the Department. Pursuant to that provision we order the Department to pay Intel $2000 in attorney's fees.

The decision of the hearing officer is affirmed.

IT IS SO ORDERED

/s/ Harris L. Hartz
HARRIS L. HARTZ, Judge

I CONCUR:

/S/ Michael D. Bustamante
MICHAEL D. BUSTAMANTE, Judge

THOMAS A. DONNELLY, Judge (Concurring in part & Dissenting in part)

DONNELLY, Judge (concurring in part and dissenting in part).

I concur in the affirmance of the administrative hearing officer's decision to allow Intel's claim to the corporate child care tax credit for payments made during the 1991 tax year.

For the reasons set forth in my dissenting opinion in *Conoco, Inc. v. Taxation & Revenue Department*, No. 15,372,

slip op. (N.M. Ct. App. May 1, 1995), I respectfully dissent from that portion of the majority decision which affirms the State Taxation and Revenue Department's denial of Intel's refund claims in the instant case. As stated in the dissent in *Conoco,* in my opinion, the Department's disparate treatment of Conoco's dividend income received from its foreign subsidiaries facially discriminates against foreign commerce and thus is contrary to *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance,* 112 S. Ct. 2365 (1992). I would reverse the administrative hearing officer's decision and grant Intel's refund claims for the tax years 1988 through 1991. Moreover, since this Court's decision was filed in *Conoco,* the Supreme Court of Rhode Island has also had occasion to rule on an analogous claim involving that state's disparate treatment of domestic and corporate dividend income in light of the decision in *Kraft General Foods. See Dart Indus., Inc. v. Clark,* Nos. 94-102-M.P., 94-439-M.P., 92-356-M.P., 91-356-M.P., 1995 WL 274466 (R.I. May 10, 1995). In *Dart Industries* the court found that Rhode Island failed to comply with *Kraft General Foods* and ordered a refund of taxes paid by the taxpayer. The court in *Dart Industries* held that the Rhode Island corporate income tax statute which required the inclusion of foreign, but not domestic, dividend income impermissibly discriminated and violated the Foreign Commerce Clause of the United States Constitution and the hoiding in *Kraft General Foods.*

/s/ Thomas A. Donnelly
THOMAS A. DONNELLY, Judge

APPENDIX D

BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PROTEST OF
CONOCO, INC., I.D. NO. 01-099105-00 0,
PROTEST TO THE DENIAL OF CLAIMS FOR
REFUND FOR TAX YEARS 1988, 1989, 1990,
AND 1991 AND TO ASSESSMENT NO. 1638288

DECISION AND ORDER

This matter came on for hearing on September 21 and 22, 1993 before Gerald B. Richardson, Hearing Officer. Conoco, Inc. (hereinafter "Conoco" or "Taxpayer") was represented by Curtis W. Schwartz, Esq. The Taxation and Revenue Department (hereinafter "Department") was represented by Bruce J. Fort, Special Assistant Attorney General. At the close of the hearing briefs were requested from the parties. The Taxpayer's post-hearing Reply Brief was filed on December 30, 1993 and the matter was considered submitted for decision at that time. Due to the complexity of the matter presented, the parties have graciously consented to granting the Hearing Officer additional time beyond the thirty days provided for in Section 7-1-24(H) NMSA 1978 to render his decision in this matter.

Based upon the evidence and arguments presented, IT IS DECIDED AND ORDERED as follows:

FINDINGS OF FACT

1. Conoco is a wholly owned subsidiary of DuPont Energy Co., a Delaware corporation. DuPont Energy Co. is a wholly owned subsidiary of E.I. duPont de Nemours and Company (hereinafter, "DuPont") a Delaware corporation.

2. Conoco's corporate headquarters and its principal place of business are located in Houston, Texas.

3. Conoco owns 100% of the stock of approximately 60 first-tier subsidiary corporations, approximately 51 of which are incorporated under the laws of various states and approximately 9 of which are incorporated under the laws of foreign countries. Conoco owns varying percentages of 132 second-tier, third-tier and fourth-tier subsidiaries, of which 34 are incorporated within the United States and 98 are incorporated under the laws of foreign countries.

4. DuPont and its domestic subsidiaries including Conoco, its foreign operating companies and its foreign subsidiaries constitute a unitary business enterprise. For purposes of this decision, "domestic subsidiaries" means subsidiary corporations incorporated within the United States whose operations are within the United States. "Foreign operating companies" means subsidiary corporations incorporated within the United States whose operations are outside of the United States. "Foreign subsidiaries" means subsidiary corporations organized under the laws of foreign countries and whose operations are outside of the United States.

5. Part of DuPont's unitary business enterprise consists of integrated oil and gas activities conducted on a world-wide basis through its subsidiary, Conoco. During the tax years at issue there were flows of products, capital, personnel, equipment and technology among these entities.

6. The majority of the refining capacity of DuPont's unitary business enterprise is located in the United States. The majority of the crude oil reserves of DuPont's unitary business enterprise are located outside of the United States. In 1991, approximately 41% of the crude oil feedstocks for DuPont's domestic refineries originates in the United States.

7. Conoco conducts business in all 50 states and the District of Columbia. The business activities of Conoco itself within the Unites [sic] States primarily consist of exploration for, and development and production of crude oil, natural gas and natural gas liquids. In addition, Conoco refines crude oil into petroleum products and markets those products.

8. In part, Conoco conducts its business activities in the United States through the ownership of stock in domestic subsidiaries. Conoco's domestic subsidiaries operate in domestic commerce and, in the aggregate, conduct business in approximately 50 states. Conoco owns 100% of the stock of most of its domestic subsidiaries.

9. The business activities of Conoco's domestic subsidiaries conducted in the United States consist mainly of the transportation of petroleum and petroleum related

products, the wholesale and retail marketing of refined petroleum products, natural gas and natural gas liquids.

10. Conoco is constantly engaged in the search for new oil and gas reserves to replace its current producing oil and gas properties. New oil and gas reserves are acquired through Conoco's own exploration activities and by purchasing known reserves from others. The exploration activities consist of identifying potential areas through information obtained from geological and geophysical efforts and careful analysis of the information developed therefrom to determine the properties' commercial capabilities.

11. Conoco owns varying percentage interests in oil and gas leases. Those leases yield oil and gas production in 16 states and the outer continental shelf. In many cases, Conoco is the operator of a particular lease. In other cases, Conoco participates as an interest owner in a joint venture. Conoco also owns royalty and overriding royalty interests.

12. Conoco disposes of its equity crude oil primarily by processing it in one or more of the refineries which it owns. In general, Conoco is a net purchaser of crude oil because its refining capabilities exceed its domestic supply of crude oil.

13. Conoco owns and operates four refineries in the United States. These refineries are located at Lake Charles, Louisiana; Ponca City, Oklahoma; Billings, Montana and Denver, Colorado. A subsidiary of Conoco owns a refinery in Santa Maria California.

14. The refineries set forth in the preceding paragraph principally refine crude oil owned by Conoco. Conoco's supply of crude oil for these refineries comes primarily from its domestic equity crude, domestic crude purchased by it from third parties, foreign crude purchased by it from third parties and exchanges with third parties. The refineries produce gasolines, diesels, aviation fuels, distillates, lubricants, coke and other products.

15. Conoco's natural gas and gas products operations consist of gathering, processing, marketing and distributing natural gas and natural gas products.

16. Conoco owns varying percentage interests in natural gas processing plants located in Colorado, New Mexico, Louisiana, Michigan, Oklahoma, Texas and Wyoming. Natural gas processing plants separate natural gas from heavier gases such as propane and butane. The latter are commonly known as liquids. The natural gas is transported through pipelines and sold to customers of Conoco, principally utilities. The liquids are transported to fractionators and terminals from which point they are marketed by Conoco to third parties. Some of the gas and gas products which Conoco owns is consumed by it.

17. Conoco operates several natural gas processing plants in which its [sic] has an ownership interest. Other natural gas processing plants in which Conoco has an ownership interest are operated by interest owners other than Conoco.

18. The natural gas processing plants process gas owned by Conoco as well as gas owned by third parties. All gas, irrespective of its ownership is processed on a fee

basis. Conoco also owns gas that is processed by plants in which Conoco has no ownership interest.

19. Conoco markets its crude oil, refined products, natural gas and natural gas products in all 50 states and the District of Columbia. Conoco does not market crude oil, refined products, natural gas or natural gas products outside of the United States. The products are distributed to Conoco customers by a network of owned and third party transport trucks, rail cars, affiliated pipeline companies and product terminals.

20. Approximately 85% of Conoco's total annual domestic sales each year are derived from sales in 15 states. The sales in each state are in excess of $100 Million. Those 15 states are: Arkansas, Colorado, Illinois, Iowa, Kansas, Louisiana, Missouri, Montana, Nebraska, New Mexico, North Carolina, Oklahoma, Texas, Washington, and Wyoming.

21. Conoco's New Mexico business activities consist primarily of (i) exploration for and production of petroleum and natural gas, (ii) gas and crude oil gathering, (iii) processing of natural gas, and (iv) marketing of natural gas and refined petroleum products.

22. Conoco produces oil and gas primarily in the northwest and southeast parts of New Mexico. Conoco owns varying percentage interests in oil and gas producing wells in New Mexico. In 1988, Conoco was the operator of approximately 1,286 wells and had interests in approximately 6,202 partner operated wells. In 1989, Conoco was the operator of approximately 1,048 wells and had interests in approximately 5,335 partner operated wells. In 1990 Conoco was the operator of approximately

1,174 wells and had interests in approximately 6,074 partner operated wells. In 1991 Conoco was the operator of approximately 1,312 wells. Information concerning partner operated wells for 1991 was not provided. In 1991, Conoco was the 5th largest oil producer and the 7th largest natural gas producer in New Mexico.

23. Conoco has small field offices located in New Mexico which oversee production operations. Until June, 1990, Conoco had a Division Office located in Hobbs. That office was responsible for exploration and production activities within all of New Mexico. In June, 1990, that office was closed and its functions were consolidated with Conoco's Midland, Texas Division Office.

24. Conoco operates two natural gas processing plants in New Mexico. One plant is located in the San Juan Basin in northwest New Mexico and the other is located in southeast New Mexico near Carlsbad. Conoco owns a 50% interest in the natural gas processing plant located in northwest New Mexico. Its partner, Amoco, owns the other 50% interest. Conoco owns a 100% interest in the plant in southeast New Mexico.

25. Conoco markets refined petroleum products throughout New Mexico through approximately 18 jobbers. Conoco also owns a products terminal in Albuquerque which distributes refined products.

26. Conoco conducts its business in foreign countries through the ownership of stock in foreign subsidiaries and foreign operating companies. These subsidiaries conduct business in approximately 25 foreign countries. Conoco owns 100% of the stock of most of its foreign subsidiaries and foreign operating companies.

The business activities of the foreign subsidiaries and foreign operating companies consist mainly of exploration for and production of petroleum and natural gas, the refining of petroleum, the processing of natural gas and the wholesale and retail marketing of refined petroleum products, natural gas and natural gas liquids.

27. Conoco's foreign subsidiaries typically conduct business only in the foreign country under the laws of which they were incorporated. There are a variety of business reasons for conducting business in a foreign country through a foreign subsidiary. Such reasons include the requirements of the foreign country, insulation of Conoco from liability in the foreign country, the marketing advantage of being perceived as a local company, greater ease in repatriating funds, greater ease in borrowing funds in the foreign country and the ability to own property and to manufacture in the foreign country.

28. Conoco, through its foreign subsidiaries and its foreign operating companies, owns leasehold acreage and/or engages in exploration activities in the following foreign countries: Somalia, Indonesia, Egypt, Gabon, France, Italy, the United Kingdom, Norway, Ecuador, Australia, Canada, Tunisia, Libya, New Guinea, Denmark, West Africa, Congo, Spain, Dubaa, the Russian Federation and Angola. It also actually produces oil and gas in Canada, the United Kingdom, Norway, the Netherlands, Egypt, Dubaa and Indonesia.

29. Conoco Limited, a subsidiary of DuPont Energy Company, owns and operates a refinery near Humber, England. Conoco owns a 25% interest in Oberrheinische Mineraloelwerke GmbH ("OMW"), a foreign corporation

that owns a refinery located in Karlsruhe, Germany. OMW is managed by a consortial committee consisting of six seats, of which Conoco controls two. No one shareholder has control of the consortial committee. DuPont's annual report for 1992 referred to the OMW refinery as "well integrated with our marketing network."

30. Natural gas processing operations located in the United Kingdom are conducted through Conoco Limited, a foreign subsidiary of DuPont Energy Company. Conoco also owns 40% of the stock of Phoenix Park Gas Processors, Ltd., a foreign corporation that operates a gas processing plant located in the Republic of Trinidad and Tobago.

31. Conoco's foreign subsidiaries and foreign operating companies are engaged in retail marketing activities in Austria, Belgium, Czechoslovakia, Denmark, France, Germany, Ireland, Luxembourg, Sweden, Switzerland and the United Kingdom.

32. Conoco Shipping Company, one of Conoco's foreign subsidiaries, conducts a shipping business through owned and leased vessels which operate in international and domestic waters, including the delivery of foreign crude oil to Conoco's Lake Charles, Louisiana refinery.

33. The entire DuPont group, including its affiliated subsidiaries, both domestic and foreign, is insured against the risk of property loss primarily through two of Conoco's foreign subsidiaries, Danube Insurance Limited and Wabash Insurance Limited, two Bermuda Corporations which are engaged in the insurance business.

34. During 1988 through 1991, Danube Insurance Limited and/or Wabash Insurance Limited owned a 2.55% ownership interest in ACE Insurance Company and a 2.3% interest in XL Insurance Company. Both ACE and XL are incorporated in Bermuda and act as reinsurers of certain insurance policies issued by Danube and Wabash.

35. Conoco receives dividends from its domestic subsidiaries, its foreign subsidiaries and its foreign operating companies. The dividends received are paid from the payor subsidiary corporations' after-tax earnings to the payor subsidiary corporations's shareholder, Conoco.

36. For federal tax purposes, pursuant to Internal Revenue Code ("IRC") Section 243, corporations are generally allowed a deduction for dividends received from domestic subsidiaries and foreign operating companies, irrespective of the domestic or foreign source of the earnings which generated those dividends.

37. DuPont filed a consolidated U.S. corporation income tax return, Form 1120, with its affiliated group as defined in IRC Section 1501. Conoco is a member of the DuPont affiliated group.

38. DuPont was entitled to and claimed the deduction allowed by IRC Section 243 for dividends received from its domestic subsidiaries and foreign operating companies for tax years 1988, 1989, 1990 and 1991, hereinafter, the relevant tax years.

39. For federal tax purposes, corporations are not allowed a deduction for dividends received from foreign subsidiaries when dividends received are derived from

the foreign subsidiaries' foreign business activities. For federal tax purposes, corporations are, however, entitled to a deduction for dividends received from foreign subsidiaries when the dividends are derived from the foreign subsidiaries' domestic business activities. Because none of Conoco's foreign subsidiaries have domestic business activities, none of their dividends paid to Conoco were deductible by Conoco for federal tax purposes.

40. In its computation of consolidated federal taxable income, DuPont generally is required by federal tax law to include in income certain amounts deemed to be received by Conoco and others of DuPont's affiliated corporations from the foreign business activities of their respective foreign subsidiaries. The above referred to amounts are, for the purposes of this case, "deemed dividends". The deemed dividends result from the application of IRC Sections 951, *et. seq.* and IRC Sections 1291, *et. seq.* Those sections, as applied to Conoco, provide that dividends are deemed to be received by Conoco from those of its foreign subsidiaries which are controlled foreign corporations and passive foreign investment companies. The majority of the dividend income deemed to be received by Conoco is "Subpart F income" and income from investment of earnings in United States property.

41. Conoco's Subpart F income consists of both "insurance income" as defined in IRC Section 953 and "foreign base company income" as defined in IRC Section 954. Conoco's subpart F insurance income and foreign base company income consist of income deemed to be distributed to Conoco from the undistributed earnings and profits of Conoco's foreign subsidiaries which are controlled foreign corporations.

42. The vast majority of Conoco's income from investment of earnings of a controlled foreign corporation in United States property results from a loan made by Conoco Mineraloel GmbH in 1991 to DuPont in the amount of $85,526,316. The loan bore interest at a rate of 10% per annum and matured in January, 1992.

43. In the 1988 DuPont consolidated federal income tax return, Conoco reported receiving a dividend in the amount of $22,086,971 and a deemed dividend in the amount of $3,689,681 from Conoco Mineraloel GmbH, a foreign subsidiary of Conoco. The deemed dividend was an actual cash dividend to Conoco or an intermediate subsidiary, but for federal tax purposes the dividend was required to be reported as a deemed dividend. DuPont's 1988 consolidated federal income tax return also reported the following deemed dividends, from the following foreign corporations in which Conoco had an equity interest:

ACE	$ 4,186,731
Petrex	193,942
XL Insurance	668,538

Although these amounts were required to be reported as deemed dividends, they were actual cash distributions to Conoco or an intermediate subsidiary.

44. The 1989 DuPont consolidated federal income tax return reported "deemed dividends" from the following foreign corporations in which Conoco had an equity interest:

ACE	$3,276,729
Conoco Mineraloel, GmbH	1,901,102
SECA	173,622
XL Insurance	21,995
Petroconstruct	21,995

Although these amounts were required to be reported as deemed dividends, they were actual cash distributions to Conoco or an intermediate subsidiary.

45. In the 1990 DuPont consolidated federal income tax return, Conoco reported receiving a dividend in the amount of $71,559,259 and a deemed dividend in the amount of $5,091,229 from Conoco Mineraloel GmbH. The deemed dividend was an actual cash dividend to Conoco or an intermediate subsidiary. DuPont's consolidated federal income tax return for 1990 also reported deemed dividends from the following foreign corporations in which Conoco had an equity interest:

ACE	$ 136,554
DuPont Scandinavia	1,424,476
XL Insurance	18,281

Although these amounts were required to be reported as deemed dividends, they were actual cash distributions to Conoco or an intermediate subsidiary.

46. The 1991 DuPont consolidated federal income tax return reported deemed dividends from the following foreign corporations in which Conoco had an equity interest:

DuPont Coordination Center	$ 669,203
DuPont Scandinavia	6,399,987
Conoco Dubaa	165,985
Conoco Faghur	279,071
South Umbarka	1,042,379
West Ras Qattara	68,392

Although these amounts were required to be reported as deemed dividends, they were actual cash distributions to Conoco or an intermediate subsidiary.

47. Federal tax laws afford taxpayers such as Conoco (in this case the DuPont affiliated group) an election to either claim a credit for or to deduct the foreign taxes paid or accrued. Conoco (actually, its parent, DuPont, on behalf of the affiliated group) elected to claim a credit for foreign taxes paid or accrued.

48. When Conoco filed its New Mexico corporation income tax returns for the relevant tax years it elected to use the separate entity reporting method as authorized by Regulation CIT 9:2 and its predecessors. Conoco filed its returns in a manner consistent with its separate entity election. Regulation Cit 9:2, as it existed during the relevant tax years, allowed Conoco to affirmatively elect, without the consent of the Department, to change its reporting method to either a combination of unitary subsidiaries or to a federal consolidated group. Conoco did not so elect.

49. For 1988, 1989, and 1990, New Mexico base income was federal taxable income as shown on line 30 of a taxpayer's federal corporate income tax return, Form

1120. For 1991 and subsequent years, New Mexico base income consists of federal taxable income as shown on line 30 adjusted to add back net operating losses claimed under IRC Section 172(a) and interest received on state or local bonds issued by a state other than New Mexico.

50. Since Conoco was a member of an affiliated group which filed a consolidated federal return, Conoco was required to prepare and file with the Department a simulated federal income tax return, which Conoco did.

51. In preparing its simulated federal income tax returns for the relevant tax years, Conoco, in accordance with IRC Section 243, deducted from income dividends it received from its domestic subsidiaries and its foreign operating companies. It did not deduct from income the dividends it received from its foreign subsidiaries.

52. By following the federal tax scheme, using federal taxable income from line 30 of the federal return, with minor adjustments, New Mexico, in effect, generally allows a deduction for dividends received by Conoco from its domestic subsidiaries and its foreign operating companies but not for dividends received by Conoco from its foreign subsidiaries.

53. New Mexico does not allow a credit for foreign taxes paid but does allow a deduction for foreign taxes paid if such a deduction is claimed by a taxpayer in lieu of the foreign tax credit.

54. Conoco filed its 1988, 1989 and 1990 New Mexico corporation income tax returns following New Mexico's tax scheme, except that it included in the denominator of the apportionment factors a portion of its

unitary dividend payor foreign subsidiaries' property, payroll and sales factors. The extent to which the factors of the dividend payor foreign subsidiaries were included in Conoco's apportionment factors was determined by Conoco by application of the "Detroit formula" or a modification thereof. By including these foreign factors in the apportionment formula calculation, Conoco granted itself "factor relief" which was not authorized by the Department. In filing its 1988, 1989 and 1990 returns with the Department, Conoco did not disclose that it was granting itself factor relief, nor did it petition the Department, pursuant to Section 7-4-19 NMSA 1978 for authorization for such factor relief.

55. As the result of the manner in which Conoco filed its 1988, 1989 and 1990 New Mexico corporation income tax returns, Conoco (i) included in New Mexico base income dividends received from its unitary payor foreign subsidiaries, (ii) included in New Mexico base income dividends deemed to be received from its unitary controlled foreign corporations and unitary passive foreign investment companies, (iii) excluded from New Mexico base income dividends received from its domestic subsidiaries and foreign operating companies, and (iv) excluded from New Mexico base income dividends (net of related expenses) received from its non unitary foreign subsidiaries.

56. In its 1991 New Mexico corporation income tax return, Conoco excluded from apportionable income all dividends and deemed dividends received from its foreign subsidiaries.

57. In its 1988 New Mexico return, Conoco reported New Mexico base income of $259,626,763. Included in the amount reported as base income were actual and deemed foreign dividends in the following amounts:

from foreign corporations (1120 Schedule C, line 13)	$ 44,269,468
subpart F income (1120 Schedule C, line 14)	22,689,092
Total	$ 66,958,560

58. In its 1989 return, Conoco reported New Mexico base income of $134,955,913. Included in the amount reported as New Mexico base income were actual and deemed foreign dividends in the following amounts:

from foreign corporations	$ 44,883
subpart F income	16,776,888
Total	$ 17,221,771

59. In its 1990 return, Conoco reported New Mexico base income of $455,587,441. Included in the amount reported as New Mexico base income were actual and deemed foreign dividends in the following amounts:

from foreign corporations	$ 75,359,391
subpart F income	23,026,855
Total	$98,386,246

60. In 1988, Conoco received dividends in the aggregate amount of $83,893,037 from its domestic subsidiaries and foreign operating companies which were excluded from New Mexico base income.

61. In 1989, Conoco received dividends in the aggregate amount of $108,329,036 from its domestic subsidiaries and foreign operating companies which were excluded from New Mexico base income.

62. In 1990, Conoco received dividends in the aggregate amount of $59,396,047 from its domestic subsidiaries and foreign operating companies which were excluded from New Mexico base income.

63. In 1991, Conoco received dividends in the aggregate amount of $89,599,976 from its domestic subsidiaries and foreign operating companies which were excluded from New Mexico base income.

64. After apportionment, using the Detroit method as applied by Conoco, Conoco's New Mexico apportioned income in the following years was:

1988	$ 5,235,547
1989	3,846,406
1990	10,922,593
Total	$20,004,546

65. Conoco paid the following amounts of New Mexico income tax for the following years:

1988	$ 377,902
1989	272,327
1990	829,575
Total	$ 1,479,804

66. On September 14, 1992, Conoco timely filed its 1991 New Mexico corporation income tax return. In that return, Conoco deducted from New Mexico base income $103,142,564 of dividends deemed to have been paid to Conoco by its unitary foreign subsidiaries which are

either controlled foreign corporations or passive foreign investment companies.

67. In its 1991 New Mexico corporation income tax return, Conoco also excluded from apportionable income $609,668 of dividends (net of related expenses) actually received by Conoco from less than 50% owned foreign corporations.

68. Conoco's 1991 New Mexico corporation income tax return reported New Mexico apportioned income of $13,263,864 and a tax liability of $1,007,379. Conoco had made tentative and or estimated New Mexico income tax payments for 1991 of $1,100,998. Accordingly, Conoco's 1991 return claimed a refund of $93,569.

69. On September 14, 1992, in accordance with Section 7-1-26 NMSA 1978, Conoco timely filed amended New Mexico corporation income tax returns for 1988, 1989 and 1990 seeking refunds of overpaid New Mexico corporate income taxes in the following amounts:

1988	$ 87,064
1989	33,474
1990	144,854

70. The total amount of Conoco's refund claims for the 1988 through 1991 tax years is $358,961.

71. By a letter dated February 11, 1993, the Department denied in full Conoco's refund claim for 1991.

72. By letters dated February 12, 1993, the Department denied in full Conoco's refund claims for 1988, 1989 and 1990.

73. On February 26, 1993, the Department issued Assessment No. 1638288 to Conoco for 1991 corporate

income taxes in the amount of $165,929, penalty in the amount of $16,593 and interest in the amount of $24,889 for a total of $207,411.

74. The Department has issued no assessments of corporate income taxes for the tax years 1988, 1989 and 1990 claiming any underpayment of taxes due to Conoco's filing of its original returns for those years claiming factor relief using the Detroit method or a modification thereof.

75. By a letter dated March 9, 1993, Conoco timely protested the denial of its refund claims for the 1988, 1989 and 1990 tax years and requested a formal administrative hearing in accordance with Section 7-1-24 NMSA 1978.

76. By a letter dated March 9, 1993, Conoco timely protested the denial of its refund claims for the 1991 tax year and requested a formal administrative hearing in accordance with Section 7-1-24 NMSA 1978.

77. By a letter dated March 19, 1993, Conoco timely protested Assessment No. 1638288 and requested a formal administrative hearing in accordance with Section 7-1-24 NMSA 1978.

78. Conoco's foreign subsidiaries operate in foreign commerce and the flow of value between Conoco and its foreign subsidiaries, including the dividends and deemed dividends received from its foreign subsidiaries constitutes foreign commerce.

79. Assessment No. 1638288 was based upon the Department including in New Mexico base income the dividends and deemed dividends which Conoco received

from its foreign subsidiaries and foreign operating companies.

80. Assessment No. 1638288 did not take into consideration the factors of Conoco's foreign subsidiaries and foreign operating companies under the Detroit formula in arriving at the amount of corporation income taxes assessed.

81. Where dividend income from a foreign subsidiary is included in the apportionable tax base of a domestic parent corporation, the Detroit formula operates to adjust the apportionment formula by including in the denominators of the parent corporation's property, payroll and sales factors a percentage of the property, payroll and sales of the dividend generating foreign subsidiary. The percentage of the foreign subsidiary's property, payroll and sales to be included is the ratio that the net dividends received from such subsidiary bears to the subsidiary's net profits, but not to exceed 100%.

82. The overall effect of applying the Detroit formula to Conoco or similarly situated taxpayer's is to reduce the apportionment figure to be applied to New Mexico base income, thereby reducing the amount of income tax due.

83. The specific effect of the application of the Detroit formula to Conoco's apportionment factor for the tax years at issue is as follows:

	Apportionment Factor As Reported	Apportionment Factor After Detroit Formula Modification
1988	2.9219%	2.5969%
1989	3.0102%	2.9874%
1990	2.9256%	2.6947%
1991	3.3099%	3.0210%

84. As compared to the exclusion of Conoco's foreign dividend income from New Mexico taxable income, the application of the Detroit formula to Conoco for the tax years in issue results in higher corporation income taxes owing to New Mexico, as shown below:

	Tax if foreign dividend income is excluded	Tax if Detroit formula is applied
1988	$ 292,761	$ 377,952
1989	$ 244,295	$ 272,377
1990	$ 684,767	$ 829,630
1991	$1,007,444	$1,156,326

85. For separate corporate entity filers with foreign dividend income, the application of the Detroit formula may result in higher, the same, or lower New Mexico corporation income taxes than would result from the exclusion of the taxpayer's foreign dividend income. The comparative effect of the application of the Detroit formula depends upon the relative efficiencies of the taxpayer's foreign and domestic operations and does not inherently treat the foreign sourced income of the taxpayer less favorably than its domestic sourced income.

86. By calculating New Mexico base income for separate corporate entity filers based upon Line 30 of federal Form 1120, New Mexico's scheme for the taxation of dividend income received from domestic and foreign subsidiary corporations of separate corporate entity filers is indistinguishable in any material or meaningful way from the Iowa corporate income tax scheme found by the United States Supreme Court in ***Kraft General Foods, Inc. v. Iowa Department of Revenue*** to facially discriminate against foreign commerce in violation of the Commerce Clause of the United States Constitution.

87. One way of eliminating the discrimination against Conoco's foreign sourced dividend income is to exclude such dividends from New Mexico taxable income.

88. The differential treatment of foreign and domestic sourced dividend income for separate corporate entity filers in New Mexico provides a basis for taxpayer's to petition for or for the Department to require an adjustment of factors under Section 7-4-19 NMSA 1978.

89. Conoco's 1991 New Mexico Corporation Income Tax return was prepared by Mr. David Conway, manager of Conoco's State Income Tax Division. Mr. Conway has a bachelors degree in Business and Economics and has thirty hours of college level accounting classes. Mr. Conway has worked in the accounting and tax departments of Conoco since 1965.

90. Prior to filing Conoco's 1991 New Mexico Corporation Income Tax return, Mr. Conway had read the ***Kraft*** decision and he determined that it could be applied

to exclude Conoco's foreign dividend income from consideration for New Mexico corporation income tax calculation purposes.

DISCUSSION

This matter arises as a result of the United States Supreme Court's decision in ***Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance***, 505 U.S. ___, 112 S.Ct. 2365 (1992), hereinafter, ***Kraft***. In that decision, the Supreme Court ruled that Iowa's corporate income tax scheme, which uses the federal definition of net income as a starting point in calculating Iowa taxable income, facially discriminates against foreign commerce in violation of the Foreign Commerce Clause, U.S. Const., Art. I, Section 8. The basis for the Court's decision is that in computing net income for federal tax purposes, the Internal Revenue Code, Section 243, provides a deduction for dividends received from domestic subsidiaries. This is done because the earnings of the domestic subsidiaries themselves are fully taxable at the federal level and the deduction avoids a second federal tax on those earnings. ***Kraft***, 112 S.Ct. at 2367. The federal government does not tax the earnings of foreign subsidiaries, so there is no concomitant deduction in the Internal Revenue Code for the dividends received from foreign subsidiaries. There is a credit provided, however, to the parent corporation for the foreign taxes paid on the dividends and on the underlying foreign earnings. IRC Sections 901 and 902. This credit is intended to mitigate the multiple taxation of corporate earnings. ***Kraft***, 112 S.Ct. at 2367. Iowa, by following the federal definition of net income in arriving

at income subject to taxation in Iowa, included the dividends received by Iowa corporations from their foreign subsidiaries, and excluded the dividends received by those corporations from their domestic subsidiaries. The Court ruled that this scheme resulted in facial discrimination against foreign commerce and thus violated the Foreign Commerce Clause.

Conoco argues that the application of ***Kraft*** to the filing methodology is [sic] has elected in New Mexico compels an identical conclusion and entitles it to the refunds which it has claimed. Before examining Conoco's contentions, a review of the New Mexico corporation income tax scheme as it relates to the taxation of income of multistate and multinational corporations will provide a context for examining the complex issues raised by this case.

Background

Like Iowa, New Mexico uses federal taxable income as shown on line 30 of a taxpayer's federal corporate income tax return, Form 1120, as the starting point (New Mexico base income) for calculating corporate income taxes. New Mexico allows corporate taxpayers to elect among four different reporting methods. Regulation CIT 9:2 provides that in filing its initial New Mexico corporate income tax return, a taxpayer may use any one of four reporting methods:

1. separate accounting
2. separate corporate entity
3. combination of unitary corporations
4. federal consolidated group.

The regulation further provides that in succeeding years, the taxpayer may elect to file on any basis with a higher ranking on the above numbered list, without prior permission of the Department. However, taxpayers will not be allowed to choose a lower ranked method without first obtaining written permission from the Department.

In order to provide a context for understanding the various allowable filing methods and their relationship to the Foreign Commerce Clause issues raised by this case, a review of the interrelationship between the Foreign Commerce Clause, the Due Process Clause and the state's ability to tax income generated in foreign commerce will be reviewed. Additionally, New Mexico's statutory method for apportioning income among multistate and multinational corporate entities, the Uniform Distribution of Income for Tax Purposes Act (UDITPA), Chapter 7 Article 4 NMSA 1978, will also be discussed.

It is fundamental under both the Due Process and Commerce Clauses of the Constitution that a state may not, when imposing an income based tax, tax value earned outside of its borders. ***See, ASARCO, Inc. v. Idaho State Tax Commission,*** 458 U.S. 307 (1982). When dealing with income that has been earned by a multistate and multinational taxpayer, determining what income has been earned by that taxpayer within a particular state can be extremely complicated and has generated a significant amount of constitutional litigation in the U.S. Supreme Court. ***See, e.g., Asarco, Container Corporation of America v. Franchise Tax Board,*** 463 U.S. 159 (1983); ***Mobil Oil Corp. v. Comm'r of Taxes of Vermont,*** 445 U.S. 425 (1980); ***F.W. Woolworth Co. v. Taxation and Revenue Department,*** 458 U.S. 354 (1982); ***Exxon Corp. v. Wisconsin***

Department of Revenue 1447 U.S. 207 (1980); ***Moorman Manufacturing Co. v. Baer,*** 437 U.S. 267 (1978); and many others. Because of the difficulty of precisely measuring a state's properly apportioned share of a multijurisdictional taxpayer's income, the Supreme Court has long held that the Constitution imposes no single formula on the states, ***Wisconsin v. J.C. Penney,*** 311 U.S. 435, 445 (1940), and has placed upon a taxpayer challenging a state's formula, the burden of showing by clear and cogent evidence that a state tax results in the taxation of extraterritorial values. ***Exxon Corporation, supra,*** 447 U.S. at 221. Historically, states attempted to account for their share of taxable income based upon systems of separate accounting whereby a company's income earned within the geographical boundaries of the state was determined based on formal corporate entities or on an attempt to segregate transactions conducted within the state. This methodology, called separate accounting, has fallen into disfavor because it was subject to manipulation and imprecision and, significantly, either ignored or failed to capture the many subtle and often unquantifiable transfers of value that take place among the components of a large, complex enterprise. ***See, generally, Mobil Oil Corp.,*** 445 U.S. at 438-439. As a result of the inadequacy of the separate accounting concept, the unitary business concept evolved. The unitary business principle generally disregards territorial boundaries and corporate structure issues. The unitary concept requires viewing a business enterprise as a single unit irrespective of whether the enterprise crosses geographic boundaries or its business is conducted through separate corporate entities. Once the scope of a unitary business is defined, the taxable

income of the total unitary enterprise is determined and an apportionment formula is applied to approximate the unitary business income which is reasonably related to the business' activities conducted within the taxing jurisdiction based upon various objective measures of the taxpayer's activities both within and without the taxing jurisdiction. The Supreme Court long ago upheld the constitutionality of the basic unitary business concept. ***See, e.g., Hans Rees' Sons, Inc. v. North Carolina, ex rel, Maxwell,*** 283 U.S. 123 (1931); ***Bass, Ratcliff and Gretson, Ltd. v. State Tax Commission,*** 266 U.S. 271 (1924); ***Underwood Typewriter Co. v Chamberlain,*** 254 U.S. 113 (1920). More recently, the Court has noted that "the linchpin of apportionability in the field of state income taxation is the unitary business principle." ***Mobil Oil Corp.***, 445 U.S. at 439. In other words, it is the unitary business principle which provides the constitutional basis for the use of an apportionment formula by the states to apportion to the states their appropriate share of corporate income.

Like many other states, New Mexico has adopted the Uniform Division of Income for Tax Purposes Act, "UDITPA", Chapter 7, Article 4 NMSA 1978 for determining the portion of income which is attributable to New Mexico for corporations having income from both within and without New Mexico. UDITPA provides a three factor apportionment formula for arriving at the portion of income subject to New Mexico tax. The UDITPA formula requires the creation of three fractions: 1) the value of a corporation's property in a given state (the property numerator) divided by its property everywhere (the property denominator); 2) the corporation's payroll in the

state (the payroll numerator) divided by its payroll everywhere (the payroll denominator); 3) and the taxpayer's sales in the state (the sales numerator) divided by its sales everywhere (the sales denominator). These three fractions are then added together and divided by three to arrive at a fraction or multiplier which is applied to the corporation's total apportionable income to arrive at the portion which can be taxed by the given state.

As noted earlier in this discussion, by regulation, the Department allows corporate income taxpayers to elect among four different reporting methods. These are described in the Department's Corporate Income Tax Publication 102, of which judicial notice is taken. Although widely discredited as an accurate methodology for determining a multijurisdictional taxpayer's income generated in separate jurisdictions, because of the impracticality of precisely determining the locus of income and expense, New Mexico still allows two versions of separate accounting. The first, simply called separate accounting, allows corporate taxpayers to report income as if its business activities were conducted by a distinct and separate entity which operated solely within New Mexico. Thus, only income generated and expenses incurred from business activities conducted within New Mexico are considered when calculating New Mexico taxable income. This option has now been limited to corporations beginning business in New Mexico prior to January 1, 1991 and is limited to five consecutive years, beginning with the first year the corporation does business in New Mexico. Section 7-2A-8(A)(4) NMSA 1978 (1993 Repl. Pamp.). The second version of separate accounting reporting is called separate corporate entity.

Under this methodology, although a corporation may be part of a federal consolidated or unitary group, it is allowed to file separately from the other members of the group. The entire income of the corporation is reported to New Mexico, and then the three factor UDITPA formula is applied to apportion the income among New Mexico and the other states in which the corporation operates. Only the income of the reporting corporation, and not of its subsidiaries or affiliates is subject to apportionment. However, the income the corporate taxpayer actually receives from its subsidiaries and affiliates in the form of dividends, interest, royalties is considered to be income of the corporate taxpayer, subject to allocation and apportionment. The third reporting method is called combination of unitary domestic corporations. Under this method, the combined income of all members[1] of the unitary business is reported to New Mexico and then allocated or apportioned to New Mexico.

Inter-company transfers, such as dividends, are excluded from consideration as income, since the total income of the subsidiary corporation paying the dividend is already included in the income subject to allocation and apportionment. Only domestic corporate members of the unitary group, however, can be included in the group for reporting purposes. Foreign subsidiaries and affiliates are excluded from the reporting group even if they are part

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[1] All members of the unitary business are included in the reporting group, regardless of whether they engage in business in the state. Application of the three factor apportionment factor will operate to segregate the non-New Mexico income from the New Mexico based income of the unitary group, and apportion only the New Mexico based income to the state.

of the unitary business group.[2] The fourth allowable filing method is called federal consolidated. Under this method, a corporation filing a federal consolidated return my [sic] elect to report the income of all of the affiliated corporations included on the federal return. The three factor formula is then applied to the income of the consolidated group to apportion the appropriate share to New Mexico. The consolidated group may include members which may be non-unitary. As with domestic combined reporting, inter-company transfers are eliminated to avoid the double counting of income.

DOES THE OPERATION OF NEW MEXICO'S INCOME TAX DISCRIMINATE AGAINST FOREIGN COMMERCE?

Conoco has consistently elected to file corporation income taxes in New Mexico using the separate corporate entity method of filing. There can be no dispute that under New Mexico's separate corporate entity method of filing, as applied to corporations with dividend income from both foreign and domestic subsidiaries, by basing the definition of New Mexico base income on line 30 of federal form 1120, that foreign dividend income is included in base income and domestic dividend income is excluded. This is identical to the treatment of the dividend income of Kraft General Foods, Inc. by Iowa, a

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[2] When the foreign affiliates and subsidiaries are included in the unitary reporting group, this reporting method is called world-wide combined reporting. While it is not statutorily allowed in New Mexico, it is used in other jurisdictions, most notably, California.

treatment which the Court ruled amounted to facial discrimination against foreign commerce in contravention of the Foreign Commerce Clause. ***Kraft***, 112 S.Ct. at 2372. It is thus clear, that when applied to corporations with dividend income from both domestic subsidiaries and foreign subsidiaries and affiliates, New Mexico's separate entity reporting method operates in the same fatally discriminatory manner against foreign commerce.

The Department posits that New Mexico's income tax scheme differs from that of Iowa, in a manner which distinguishes this case from Kraft, and compels a different result. The Department argues that in footnote 23 of ***Kraft***, the Court in fact specifically approved domestic combined reporting as not discriminating against foreign commerce. Since Conoco could have elected to report its taxes to the Department in each of the tax years at issue using domestic combined reporting, the Department contends that Conoco may not claim discrimination and it is not entitled to a refund of taxes. In other words, the Department is arguing that evaluating a claim of discrimination under the Commerce Clause requires an examination of the operation of the state's entire tax structure to determine whether the state imposes a greater tax burden upon interstate or foreign commerce. This is the proper analysis under the Commerce Clause. ***See, Halliburton Oil Well Cementing Company v. Reily***, 373 U.S. 64, 69-70, 83 S.Ct. 1201, 1204 (1963), and cases cited therein. For the Department's argument to prevail, however, it must be determined that either the Supreme Court was referring to domestic combined reporting in footnote 23, or that, applying the analysis suggested in the footnote, the application of domestic combined reporting would not

result in greater burdens being imposed upon foreign commerce under New Mexico's methodology which treats domestic and foreign dividend income disparately.

a) The meaning of footnote 23

Before analyzing the footnote itself, a description of Iowa's corporate income taxation scheme will give a context for the analysis. As described by Conoco's expert witness, Bruce Daigh, during the years relevant to the ***Kraft*** decision, Iowa's statutes mandated that corporations report on a separate entity basis. However, Iowa had an election by which taxpayers could elect to file on a modified combined basis. It differed from domestic combined reporting in that only those entities of the unitary group with operations in Iowa could be included in the group for Iowa reporting purposes. It was also clear that Iowa's combined reporting is limited to domestic entities and is not a world-wide combined reporting methodology, because Iowa's counsel stated that a company would not have the option to have its foreign earnings taxed, (as part of a worldwide combined group) rather than just its foreign dividends taxed. ***See***, Tr. of Oral Arg. 37, as set forth at page 15 of Conoco's Reply Brief.[3]

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[3] Footnote 9 of the *Kraft* decision, which provided that, "Iowa is not a State that taxes an apportioned share of the entire income of a unitary business, without regard for formal corporate lines.", cited this portion of the transcript of oral argument and also cited the Court's *Container* decision. Because of the reference to foreign earnings rather than foreign dividends, I am convinced that the Court was referring to Iowa not having a world-wide combined reporting system and was not referring to domestic combined reporting.

Turning to footnote 23, it states:

> If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent.
>
> In considering claims of discriminatory taxation under the Commerce Clause, however, it is necessary to compare the taxpayers who are "most similarly situated." ***Halliburton Oil Well Cementing Co. v. Reily,*** 373 U.S. 64, 71, 83 S.Ct. 1201, 1205, 10 L.Ed.2d 202 (1963). A corporation with a subsidiary doing business in Iowa is not situated similarly to a corporation with a subsidiary doing business abroad. In the former case, the Iowa operations of the subsidiary provide an independent basis for taxation not present in the case of the foreign subsidiary. A more appropriate comparison is between corporations whose subsidiaries do not do business in Iowa.

If one were to make the analysis suggested by the Court in the second paragraph of the footnote, that is, compare Iowa's tax treatment of earnings and dividend income from two subsidiaries, one domestic and one foreign,

neither of which do business in Iowa, Iowa's tax scheme would still impose more burdens on foreign commerce than domestic. This is because, under Iowa's modified combined reporting methodology, both the domestic subsidiary's earnings[4] and its dividends paid to the Iowa parent would be excluded from taxation. A foreign subsidiary's earnings would be excluded, but the dividends it pays to its parent with nexus in Iowa would be subject to tax. However, if we engage in the same analysis using the normal domestic combined reporting method, the results do not demonstrate unequal burdens upon foreign vs. domestic commerce. The difference lies in the fact that under normal domestic combined reporting, the earnings of the domestic subsidiary would be included in the tax base even though the subsidiary does no business in the state. It would be left to the apportionment formula to determine what part of those earnings would be taxed. The result is identical to that reached in the first paragraph of footnote 23. The state would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent. Whether the Court was aware in writing footnote 23 that it was describing the tax effect for a state with domestic combined reporting which uses federal line 30 income as a starting point is immaterial. Application of the Court's suggested analysis to the domestic combined reporting method produces a result for which "it would be difficult

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[4] Under Iowa's modified domestic combined reporting system, the earnings of a unitary subsidiary would be excluded when the subsidiary does not do business in Iowa.

to say that [the state] discriminates against the business with the foreign subsidiary. ***Kraft***, footnote 23.

Conoco may be entirely correct in its argument that in footnote 23 the Court was merely describing the proper analysis to be applied to Iowa's taxing scheme and did not intend to make a statement about the non-discriminatory results from applying domestic combined reporting. Nonetheless, the Court did set forth what it considered to be a correct comparison for purposes of analyzing discrimination against foreign commerce. When that test is applied against domestic combined reporting, the clear suggestion of the Court's analysis is that the application of domestic combined reporting to the foreign dividend income of a unitary business does not discriminate against foreign commerce.[5] This was also the conclusion of the Kansas Supreme Court in its recent decision, ***In the Matter of the Appeal of Morton Thiokol, Inc.***, No. 67,954 (December 10, 1993). Thus, it appears that New Mexico does offer taxpayers, such as Conoco, an option to file in a manner which protects them from the very discrimination Conoco claims to be victim to.

Assuming, but not deciding that New Mexico's domestic combined filing methodology provides a non-discriminatory alternative for taxpayers with dividend

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[5] It is recognized by this decision-maker that, on analysis, footnote 23, merely suggests that domestic combined reporting is nondiscriminatory. In order to fully answer that question, an analysis of the operation of the entire taxing scheme and not just the operation of domestic combined reporting on the tax base itself, would need to be examined. ***See***, discussion, p. 42, ***post***.

income from foreign sources, the question still remains as to whether Conoco's option to file on a domestic combined basis bars its claim of discrimination herein. While there may be a certain equitable appeal to the concept that one cannot complain of discrimination if options which avoid the discrimination are given, the Department has cited to no authority which supports this proposition. There are also equitable considerations which support Conoco's position. Specifically, Conoco is filing its taxes pursuant to a reporting methodology which the Department has explicitly granted it by Regulation CIT 9:2.[6] Even if Conoco wanted to change its reporting methodology and file amended returns for the tax years at issue under the domestic combined method, Regulation CIT 9:2 expressly prohibits it by providing that, "[N]o retroactive election of a different method for reporting New Mexico state income tax will be permitted." Lest there be any doubt of Conoco's ability to rely upon the filing method allowed it by regulation, Section 7-1-60 NMSA 1978 provides clear guidance. In pertinent part, it provides:

> In any proceeding pursuant to the provisions of the Tax Administration Act, the

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[6] It is interesting to note that there is specific statutory authority for the other three methods. Separate accounting is authorized in Section 7-2A-8(A)(4) NMSA 1978. Domestic combined reporting is authorized in Section 7-2A-8.3 NMSA 1978. Federal consolidated reporting is authorized in Section 7-2A-8.4. While there is no specific statutory authority for separate corporate entity reporting, Section 7-2A-9(B) grants the Secretary of the Department the authority to prescribe the form and content of corporate tax returns, which the Secretary has exercised by promulgating Regulation CIT 9:2.

> department shall be estopped from obtaining or withholding the relief requested if it is shown by the party adverse to the department that the party's action . . . was in accordance with any regulation effective during the time the asserted liability for tax arose. . . .

In this case, the Taxpayer's protest to the denial of its refund claims as well as its protest to the Department's assessment are proceedings brought pursuant to Section 7-1-24 of the Tax Administration Act. Since Conoco filed its returns in compliance with an election granted to it by regulation, the Department is estopped from denying Conoco the benefit of that filing methodology and may not deny it any rights (including the right to argue discrimination under the Foreign Commerce Clause and to request constitutional application of the separate corporate entity filing method) inherent with the filing methodology the Department authorized.

As noted above, there is nothing which distinguishes New Mexico's separate entity filing methodology from that of Iowa's with respect to the treatment of foreign versus domestic dividend income. Application of ***Kraft*** to Conoco, results in the conclusion that, as applied to corporations with dividend income from foreign subsidiaries, New Mexico's separate corporate entity filing method results in discrimination against those companies in contravention of the Foreign Commerce Clause.

THE QUESTION OF REMEDIES

a) Is the Department limited to refunding the tax overpayment or may it fashion another remedy to the discrimination complained of?

Conoco argues that New Mexico law provides that a tax refund is the exclusive remedy for illegally collected taxes. For authority, Conoco cites to a Santa Fe County unpublished district court opinion, ***Burns, et. al. v. State of New Mexico ex. rel. Taxation and Revenue Department***, Santa Fe County Cause No. SF 89-1314(C), provisions of the Tax Administration Act, and ***Hackman v. Director of Revenue***, 771 S.W.2d 77 (Mo. 1989) ***cert. denied***, 493 U.S. 1019 (1990), the Missouri decision upon which the ***Burns*** decision relied. In response, the Department relies upon ***McKesson Corporation v. Division of Alcoholic Beverages and Tobacco***, 496 U.S. 18, 110 S.Ct. 2238, 110 L.Ed.2d 17 (1990), where the Court held that under the Due Process Clause, (which requires a fully adequate post-deprivation procedure), "a State found to have imposed an impermissible discriminatory tax retains flexibility in responding to this determination." ***Id.*** at 2252.

It is clear from a reading of ***McKesson***, that due process only requires that the state provide a remedy where, "the resultant tax actually assessed during the contested tax period reflects a scheme that does not discriminate against interstate [foreign, in this instance] commerce." ***Id.*** at 2252. Thus, there is no federal mandate that Conoco be given a refund, if an alternative remedy is offered which can meet both Foreign Commerce Clause and Due Process Clause concerns. For Conoco's argument to prevail, it must rest on an independent state law basis.

I am not persuaded that one exists. A review of the relevant provisions of the Tax Administration Act concerning refunds of tax overpayments, Sections 7-1-2(I), 7-1-26 and 7-1-29 NMSA 1978 reveals only permissive language concerning the application for and the granting of tax refunds. New Mexico has no comparable provision to Missouri[7], upon which the decision in the ***Hackman*** case was premised, which mandates the refund of overpaid taxes. Additionally, the issue being addressed by the District Court in the ***Burns*** case was not whether a refund of tax was the only appropriate remedy among several being offered, but whether the plaintiffs were entitled to retroactive as opposed to prospective relief from an unconstitutional tax. Retroactivity of relief is not an issue herein. The Department has conceded that any determination of unconstitutionality should be given retroactive application to this taxpayer for the years at issue. I find nothing in the relevant tax statutes, or in the authorities presented which persuades me to conclude that the legislature intended to circumscribe the state's available remedies for discriminatory taxation to a refund of taxes.[8]

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[7] The text of the Missouri statute is cited in Conoco's Post Hearing Brief, p. 22.

[8] The Department argues that the availability of combined and consolidated reporting for Conoco should obviate the need to provide any other remedy for Conoco. Department's Post Hearing Brief, pp. 9-11. As noted above, however, Conoco would be barred by the Department's Regulation CIT 9:2 from filing amended returns using a different filing methodology, since the effect would be to retroactively change filing methods. I believe that the regulation and Section 7-1-60 would bar the Department from requiring Conoco to file using those methodologies.

b) Does application of the Detroit formula of factor relief to Conoco adequately remedy the discrimination against foreign commerce?

The Department proposes to apply the "Detroit formula" of factor relief to Conoco for the years in question to remedy the facially discriminatory application of the separate corporate entity filing method to taxpayers with foreign dividend income. The Detroit formula is named after the agreement reached between the city of Detroit and Ford Motor Company regarding the tax treatment of Ford's foreign dividends under the Detroit income tax. The agreement is set forth in 1 Hellerstein, *State Taxation: Corporate Income and Franchise Taxes,* 558 (1st ed. 1984). As proposed by the Department, the formula would operate as follows. Where dividends from a foreign subsidiary are included in the apportionable tax base of a domestic parent, the apportionment formula would be modified by including in the denominators of the parent corporation's property, payroll and sales factors a percentage of the property, payroll and sales of the dividend generating foreign subsidiary. The percentage of the foreign subsidiary's property, payroll and sales to be included is the ratio that the net dividends received from such subsidiary bears to the subsidiary's net profits, but not to exceed 100%. The overall effect of applying the Detroit formula to Conoco or similarly situated taxpayers is to reduce the apportionment factor to be applied to New Mexico base income, thereby reducing the amount of income tax due.

Conoco disputes that the application of the Detroit formula eliminates the facial discrimination it complains of, and argues that it is therefore not an appropriate or

sufficient remedy. In making this argument, Conoco is not disputing the fairness of the Detroit formula as a means of apportioning its foreign based income. In fact, Conoco used the formula itself, without the knowledge or consent of the Department, in filing its original corporate tax returns for the 1988, 1989 and 1990 tax years. It contends, however, that the application of the Detroit formula does not remediate the discrimination it complains of. Conoco is correct in its assertion that any proposed remedy must cure the discriminatory effect complained of. As noted by the Court in *McKesson:*

> In order to cure the illegality of the tax as originally imposed, the State must ultimately collect a tax for the contested tax period that in no respect impermissibly discriminates against interstate commerce.

Id. 496 U.S. at 43, fn. 27.

To demonstrate that application of the Detroit formula did not eliminate the discrimination which Conoco alleged was inherent in New Mexico's separate corporate entity filing method as applied to corporations with both domestic and foreign subsidiary dividend income, Conoco produced the following evidence. Dr. Brian McDonald, an expert witness in economics testified that the Detroit formula is not "economically equivalent" to the exclusion of foreign dividend income. By economic equivalence, Dr. McDonald testified that he meant that for both methods to be economically equivalent, their application must result in the same amount of tax due. Dr. McDonald testified that, based upon his examination of three years of Conoco's records, Conoco would always pay a higher amount of tax to the Department under the

Detroit formula than if it excluded its foreign dividend income. Dr. McDonald could not make the same prediction for any corporations other than Conoco. Under cross-examination, Dr. McDonald admitted that if the overseas operations of a domestic parent are less efficient at generating dividend income (meaning that they would have a lower ratio of earnings to the factors generating those earnings) than the parent's domestic subsidiaries, application of the Detroit formula would result in lower taxes under New Mexico's separate entity filing method than would result from the exclusion of the foreign dividend income. Conoco produced a second expert witness, Mr. Bruce Daigh, CPA, the partner in charge at Price Waterhouse for state and local taxation for 16 western states, an expert in state taxation. He produced documentation, Taxpayer's exhibits A through D, which demonstrated that for each of the tax years at issue, application of the Detroit formula to Conoco resulted in higher New Mexico income taxes than would the exclusion of Conoco's foreign dividend income. *See*, Finding No. 84. From this analysis, he concluded that the application of the Detroit formula does not eliminate the foreign dividend income from the tax base upon which income tax is calculated, resulting in a "defective tax base" under commerce clause analysis. Under cross-examination, Mr. Daigh admitted that the application of the Detroit formula to Conoco results in the fair apportionment of Conoco's income to New Mexico, but he denied that it remedied the defective tax base to which he earlier referred.

The Department also presented two expert witnesses, both in economics. Dr. Steven M. Sheffrin testified that if New Mexico gave factor relief under the Detroit formula,

that this would result in New Mexico only taxing income earned in New Mexico and, thus, it would not be taxing Conoco's foreign dividend income. He further testified that the application of the Detroit formula to separate entity filers would more accurately reflect the income in New Mexico of those corporations with foreign dividend income, than would the exclusion of those corporation's foreign dividend income from the tax base. Finally, he testified that with factor relief under the Detroit formula, that there would be no discrimination against foreign commerce for those corporations with foreign dividend income since the apportionment under the Detroit formula results in the taxation of only New Mexico income. The Department's second witness, Dr. Al Maury, testified that in comparing the tax effect of the application of the Detroit formula versus exclusion of foreign dividend income for separate entity filers, whether the application of the Detroit formula resulted in higher, the same, or lower taxes than the exclusion of foreign dividend income depended upon the relative efficiencies of a taxpayer's foreign and domestic operations. Efficiency is a function of the comparative profitability of the operations when compared to the resources needed to produce such income. Dr. Maury testified that when a taxpayer's foreign operations are more efficient than its domestic operations, that application of the Detroit formula results in higher New Mexico taxes than the exclusion of foreign dividend income. However, where the efficiencies are the same, there is no differential tax effect between exclusion of foreign dividend income and the application of the Detroit formula. Conversely, where the foreign operations are less efficient than a taxpayer's domestic operations,

application of the Detroit formula results in a lower New Mexico tax burden than if the taxpayer excluded all foreign dividend income. Finally, Dr. Maury testified that over the long term, it is fair to assume that the domestic and foreign efficiencies will tend to equalize. Under cross-examination, Dr. Maury testified that he had estimated that the state of New Mexico would realize an approximate $3 million loss annually if the Detroit method were to be applied to all taxpayers similarly situated to Conoco.

The first issue to be determined in evaluating the adequacy of the Detroit formula remedy offered by the Department is whether fair apportionment can remedy discrimination. The Department contends that it does, by assuring that New Mexico is only taxing income, which, as determined by a fair apportionment formula, is sufficiently related to the Taxpayer's activities in New Mexico. The Department argues that the apportionment formula has the effect of eliminating any of Conoco's foreign sourced dividend income from the New Mexico tax base.

Conoco cites to ***Westinghouse Electric Corp. v. Tully***, 466 U.S.388, 398-399; 104 S.Ct. 1856, 1862-1863 (1984) for the proposition that fair apportionment cannot cure a facially discriminatory statute. This case involved a Commerce Clause discrimination challenge to the manner in which New York allows corporations a tax credit upon accumulated income of a subsidiary Domestic International Sales Corporation (DISC). New York used the three factor UDITPA apportionment formula to apportion its share of the accumulated DISC income to the state. The Court found that the constitutionality of New York's apportionment formula was a different issue, which was

irrelevant to the issue of discrimination before the Court. As stated by the Court, " 'Fairly apportioned' and 'non-discriminatory' are not synonymous terms." *Id.* 466 U.S. at 399, 104 S.Ct. at 1863.

Of course, apportionment and non-discrimination are separate concepts. If they weren't, there would only need be three parts to the traditional four part test for constitutionality first set out in the seminal case, ***Complete Auto Transit v. Brady***, 430 U.S. 274, 279 (1977). Apportionment assures that the taxing jurisdiction is only taxing income which is sufficiently related to the taxpayer's activities within the state. Discrimination involves an examination of whether foreign versus domestic or interstate versus intrastate commerce are unequally burdened.[9] I am uncertain whether the inclusion of foreign factors under the Detroit formula totally eliminates all foreign based dividend income from taxation. As just noted, apportionment attempts to assure that the income which is being taxed is sufficiently related to the taxpayer's activities in this state. If you look at the situation presented here, application of the Detroit formula to a separate entity reporting taxpayer, we have a truly hybrid system. We have added some amount of formulary apportionment to a separate accounting method of reporting. It is widely acknowledged that separate accounting fails to capture the many subtle and often unquantifiable transfers of

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[9] While fair apportionment and discrimination are separate concepts which require independent analysis under the Commerce Clause, this does not preclude the possibility that the effect of the application of an apportionment formula may offset any potential discriminatory effect of other provisions of a tax structure, as will be seen below.

value that take place among the components of a large, complex enterprise. ***See, Mobil Oil Corp.***, 445 U.S. 438-439. Three of the expert witnesses who testified in this case were advocates of formulary apportionment as a better system for capturing appropriate values for taxation purposes. Thus, what we have is a system which starts with a tax base which may not accurately reflect Conoco's true New Mexico income picture to begin with, regardless of its foreign or domestic sources, and we attempt to refine the focus by applying what is widely acknowledged to be a fair apportionment formula to it. Given this situation, I believe that it is impossible to say with certainty that no single dollar of foreign dividend income remains subject to taxation.

This brings us to Conoco's "defective tax base" issue. Its expert witness, Bruce Daigh, testified that as long as there is any part of Conoco's foreign dividend income in the tax base, the tax base is constitutionally defective, (presumably because it is facially discriminatory).[10] I have found no reference in the entire Supreme Court jurisprudence on discrimination under the Commerce Clause which speaks of a constitutionally defective tax **base**. There is lots of jurisprudence about discriminatory taxes. Those cases examine the entire taxing scheme, not just the tax base itself before credits, adjustments, apportionment, etc. are applied, to determine if discrimination exists. As noted at p. 29, ***ante.*** in evaluating a claim of

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[10] Mr. Daigh did not state the basis for his conclusion that the tax base was constitutionally defective because he was not allowed to testify as to the ultimate legal issue in this case, whether discrimination against foreign commerce existed.

discrimination, the operation of the entire tax scheme, must be considered. Lest there be any doubt that the Court in ***Kraft*** considered this to be the appropriate standard, it stated that:

> We have no reason to doubt the assertion of the United States that "[i]n evaluating the alleged facial discrimination effected by the Iowa tax, it is not proper to ignore the operation of the other provisions of the ***same*** statute." (quoting from the Brief for the United States).

Id. 112 S.Ct. at 2371. Thus, it is immaterial whether the calculation of the tax base itself operates in a manner which results in discriminatory treatment of the portion of it coming from foreign commerce. The relevant inquiry is whether the operation of the tax, (in this case, the application of the separate entity filing method with the foreign factors included in the parent company's factors under the Detroit formula) as a whole, discriminates against foreign commerce.

Supreme Court precedent concerning discrimination under the Commerce Clause categorizes the discrimination in three ways:

> a tax may violate the Commerce Clause if it is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce. (Citing Smith, State Discriminations against Interstate Commerce, 74 Calif.L.Rev. 1203, 1239 (1986)).

Amerada Hess Corp. V. Director, Division of Taxation, 490 U.S. 66, 75, (1989). Facial discrimination is described in the law review article cited above:

> When a regulation is discriminatory on its face, the very terms of the regulation deal unequally with people inside and outside the state. There is no need to resort to any additional information – except perhaps matters known to everyone – to discern that the state has given an advantage to insiders.

Smith, supra, at 1239. Although the article refers to discriminations against interstate commerce, the classifications of discrimination should equally apply to foreign commerce. Conoco's challenge to the Department's corporate tax scheme for separate entity filers alleges facial discrimination, on the basis that the differential treatment of foreign as opposed to domestic dividend income is indistinguishable from Iowa's tax treatment of the same, which the Court found to be facially discriminatory in ***Kraft***. Conoco challenges the Department's proposed remedy, the Detroit formula, on the same basis, facial discrimination, arguing that apportionment under the Detroit formula will not remedy a constitutionally defective tax base. Conoco's Post-Hearing Brief, p. 9.

Before examining the evidence on the issue on discrimination, it may be helpful to review the standard of proof upon those making a facial challenge to the constitutionality of a taxing scheme. As noted by Chief Justice Rehnquist in his dissent in ***Kraft***:

> The burden on one making a facial challenge to the constitutionality of a statute is heavy; the litigant must show that "no set of

> circumstances exists under which the Act would be valid. The fact that [the tax] might operate unconstitutionally under some conceivable set of circumstances is insufficient to render it wholly invalid. ***United States v. Salerno***, 481 U.S. 739, 745, 107 S.Ct. 2095, 2100, 95 L.Ed.2d 697 (1987).

Id., 112 S.Ct at 2372.

Turning to the issue of discrimination, Conoco's proof of discrimination essentially boils down to a showing that, even after the application of the Detroit formula, it will pay more taxes than it would if all foreign dividend income is excluded. This simply does not meet Conoco's burden of proving facial discrimination. This is especially true in light of the other evidence concerning the effect of the application of the Detroit formula. Both the Department's expert witness, Dr. Maury, and the Taxpayer's expert witness, Dr. McDonald, testified that whether application of the Detroit formula resulted in higher or lower taxes than the exclusion of foreign dividend income was a function of the relative efficiencies of a taxpayer's domestic and foreign operations. In fact, both agreed that if the domestic parent's domestic operations were more efficient than their overseas operations, that application of the Detroit formula would result in lower New Mexico taxes than would the exclusion of foreign dividend income. The tax effect of the application of the Detroit formula is entirely dependent upon the relative efficiencies of taxpayers domestic and international operations. It is not dependent on the foreign or domestic source of the income taxed. There is no inherent

unequal treatment of or facial discrimination against foreign commerce.[11]

Since Conoco's 1988, 1989 and 1990 original returns included its foreign dividend income and reported tax after applying the Detroit formula, Conoco has reported and paid the appropriate amount of corporation income tax for those years. Its claims for refund for those years based upon the exclusion of its foreign dividend income are hereby denied for the reasons stated herein. With respect to Conoco's 1991 claim for refund, based upon the exclusion of its foreign dividend income, it, too, is denied. With respect to the Taxpayer's protest to the Department's assessment for 1991, it is partially upheld and partially denied. The assessment did not calculate Conoco's tax liability based upon the application of the Detroit formula to it. To the extent that the assessment exceeds the amount of taxes which would be owing if the Detroit formula is applied, the Department is hereby ordered to abate that portion of the assessment.

PENALTY

The Department's assessment for 1991 corporate income taxes assessed $16,593 in penalty. Conoco's 1991 return was filed in September of 1992, well after the ***Kraft*** decision was decided. Mr. Conway had read the decision

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[11] Although Conoco only raised a facial discrimination claim, given the fact that the tax consequences of the application of the Detroit formula turn on circumstances other than the domestic or foreign nature of the income itself, it would also appear that Conoco could not prove discrimination against foreign commerce in effect.

and believed that it was applicable to its New Mexico tax filing. Accordingly, he prepared Conoco's return excluding Conoco's foreign dividend income from consideration for New Mexico tax purposes.

Penalty may be assessed by the Department:

> [i]n the case of failure, due to negligence or disregard of rules and regulations, but without intent to defraud, to pay when due any amount of tax required to be paid.

Section 7-1-69(A) NMSA 1978. The Department's Regulation TA 69:3 generally defines "negligence" in terms of carelessness, erroneous belief, inadvertence, inattention, and failure to exercise that degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances.

The Department's Regulation TA 69:4 gives examples which the Department considers to indicate that a taxpayer was not negligent. Pertinent here is example 4:

> the taxpayer proves that the failure to pay tax or to file a return was caused by reasonable reliance on the advice of competent tax counsel or accountant as to the taxpayer's liability after full disclosure of all relevant facts; . . .

The regulation does not define "accountant". Although there was no evidence that Mr. Conway is a certified public accountant, he did testify that he had taken thirty hours of accounting courses. The regulation also refers to the competency of the accountant or tax counsel. The facts of this case demonstrate that Mr. Conway, at the time he prepared the 1991 return, had been entrusted by

Conoco, a large, multistate and multinational taxpayer, with the complex tax of managing the reporting of all of its state taxes. Mr. Conway demonstrated a thorough grasp of the complexities involved in such a responsible position. Just a review of the returns which were submitted for the years in question reveals that a high level of sophistication in the area of state taxation is required to make such filings. Indeed, I suspect that there are many CPAs which would have difficulty handling the complexity of the state tax filings for which Mr. Conway was responsible. I have little doubt of Mr. Conway's competency to prepare the returns filed and I have little difficulty concluding that he qualifies as an accountant under the Department's regulation.

I also have little difficulty determining that as manager of Conoco's State Tax Division, Conoco relied upon Mr. Conway's expertise in preparing and filing its New Mexico tax return. That is the function of a tax department manager. Under these circumstances, Conoco was not negligent and the penalty should be abated.

CONCLUSIONS OF LAW

1. Pursuant to Section 7-1-24 NMSA 1978, Conoco filed timely, written protests to the Department's denials of its refund claims for 1988, 1989, 1990 and 1991; and Conoco filed a timely, written protest to Assessment No. 1638288. Accordingly, jurisdiction lies over both the parties and the subject matter of this protest.

2. Conoco's dividend and deemed dividend income from its foreign subsidiaries is income from foreign commerce.

3. There is no reason to treat Conoco's foreign sourced "deemed dividend" income any differently than its actual foreign sourced dividend income for purposes of Commerce Clause analysis.

4. As applied to Conoco, which has elected to report New Mexico corporate income taxes on a separate corporate entity basis and which has received dividend income from both foreign and domestic subsidiaries, New Mexico's corporate income tax scheme facially discriminates against Conoco's foreign source dividend income in contravention of the Foreign Commerce Clause of the United States Constitution.

5. Pursuant to Section 7-1-60 NMSA 1978, Conoco is entitled to rely upon the separate corporate entity filing method it has chosen pursuant to Regulation CIT 9:2 and the Department is estopped from applying or requiring Conoco to file by any other reporting method for the tax years in issue.

6. Although granting the refunds requested by Conoco is one way to remedy the unconstitutional discrimination which Conoco suffers under New Mexico's corporate income tax scheme, the Department may fashion any remedy it chooses, so long as the remedy has the effect of eliminating the discrimination complained of.

7. For purposes of analyzing whether discrimination exists under the Commerce Clause, there is no such thing as a constitutionally defective tax base. The entire operation of the state's taxing scheme must be analyzed to determine if it operates in a discriminatory manner.

8. Whether a tax is fairly apportioned and whether a tax discriminates against foreign commerce are two separate concepts which must be analyzed separately under the Commerce Clause. Nonetheless, the operation of an apportionment scheme may have the effect of altering a tax scheme in such a way as to remedy an otherwise discriminatory taxing scheme.

9. As compared with the total exclusion of a separate corporate entity filer's foreign dividend income, the application of the Detroit formula may result in equal, higher, or lower New Mexico corporation income taxes. Because the tax result turns on the relative efficiencies of the taxpayer's domestic and foreign operations, and not upon the foreign or domestic source of the taxpayer's income, the application of the Detroit formula remedies the discrimination caused by the inclusion of the taxpayer's foreign dividend income while its domestic dividend income is excluded from consideration.

10. Conoco was not negligent in excluding its foreign dividend income from New Mexico base income when filing its 1991 New Mexico corporation income tax return, based upon the judgment of its tax manager and accountant.

For the foregoing reasons, the Taxpayer's protest is granted in part and denied in part. It is hereby ordered that the Taxpayer's refund claims for 1988, 1989, 1990 and 1991 are denied in full. The Department is ordered to abate all penalty assessed by Assessment No. 1638288. The Department is further ordered to abate the portion of the tax and interest assessed by Assessment No. which

exceeds the amount of tax and interest which would be owing if the Detroit formula is applied to the Taxpayer.

Done, this 4th day of February, 1994.

/s/ Gerald B. Richardson
Gerald B. Richardson
Hearing Officer
Taxation and Revenue
Department
PO Box 630
Santa Fe, N.M. 98509-0630

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing Decision and Order were served upon the parties by mailing a copy to Curtis W. Schwartz, Esq., c/o Modrall, Sperling, Roehl, Harris & Sisk, P.A., PO Box 9318, Santa Fe, NM 87504-9318 and by hand-delivering a copy to Bruce J. Fort, Esq., all on this 4th day of February, 1994.

/s/ Gerald B. Richardson

APPENDIX E

BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PROTEST OF
INTEL CORPORATION TO THE DENIAL OF
CLAIMS FOR REFUND AND PROTEST TO
ASSESSMENT NO. 1775546, NEW MEXICO
I.D. NO. 01-130029-00 9.

DECISION AND ORDER

This matter came on for hearing before Gerald B. Richardson, Hearing Officer, on March 30 and 31, 1994. Intel Corporation (hereinafter "Intel" or "Taxpayer") was represented by Curtis W. Schwartz, Esq. of Modrall, Sperling, Roehl, Harris & Sisk, P.A. and Paul H. Frankel, Esq. of Morrison & Foerster. The Taxation and Revenue Department (hereinafter "Department") was represented by Bruce J. Fort, Special Assistant Attorney General. After the hearing, post-hearing briefs were submitted, the last briefs being filed on July 20, 1994 and the matter being considered submitted for decision on that date. The parties have extended the time for rendering the decision in this matter until September 2, 1994.

Based upon the evidence and arguments submitted, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. Intel is engaged in the business of manufacturing and selling microcomputer components (primarily semiconductor chips and printed circuit boards), modules, systems and providing ancillary services related thereto.

2. Intel's corporate headquarters and its principal place of business are located in Santa Clara, California. California is Intel's commercial domicile. Intel's legal domicile since May 3, 1989 has been Delaware. Prior to that date, Intel's legal domicile was California.

3. Intel owns directly or indirectly 100% of the stock of approximately 70 subsidiary corporations, approximately 23 of which are domestic subsidiaries incorporated in the United States and approximately 47 of which are foreign subsidiaries which are organized under the laws of foreign countries and operate exclusively outside of the United States.

4. Intel itself conducts business in approximately 40 states, including New Mexico. Intel's New Mexico business activities consist primarily of the fabrication of microcomputer components at its plant located in Sandoval County, New Mexico which is the largest silicon wafer fabrication plant in the world.

5. Intel, through its foreign and domestic subsidiaries, engages in a worldwide unitary manufacturing and sales operation. Almost all of the U.S. based operations of Intel and its subsidiaries are conducted through the parent, Intel. The activities of Intel at the Sandoval County plant are an integral part of those worldwide operations. Silicon wafers are processed in Sandoval

County, then shipped to Malaysia, the Philippines or other plants where the wafers are cut into individual chips, tested, and prepared for installation in computers and computer components.

6. Approximately six of Intel's 23 domestic subsidiaries are engaged principally in overseas (non-U.S.) sales activities.

7. As shown on its New Mexico Corporation Income Tax returns, form CIT-1, Intel's average apportionment factor in New Mexico during the four years at issue was:

Year	Factor
1988	6.3960%
1989	7.5441%
1990	8.7550%
1991	10.4822%

8. Approximately 80% of Intel's domestic subsidiaries operate only in domestic commerce. The remaining domestic subsidiaries operate in foreign commerce. Intel owns directly or indirectly 100% of the stock of each of its domestic subsidiaries.

9. Intel's foreign subsidiaries operate in foreign commerce and conduct business in approximately 30 foreign countries. Intel owns directly or indirectly 100% of the stock of each of its foreign subsidiaries. The business activities of Intel's foreign subsidiaries consist of sales and distribution activities, manufacturing and financial activities.

10. The foreign subsidiaries typically conduct business only in the foreign country under the laws of which they were incorporated. There are a variety of business reasons for conducting business in a foreign country through a foreign subsidiary incorporated under the laws of the foreign host country. Such reasons include, but are not limited to, a better ability to limit Intel's liability in the foreign country, the marketing advantage of being perceived by customers as a local company, greater ease in repatriating funds, greater ease in borrowing funds locally in the foreign country, tax considerations, and the ability to own property and to manufacture in the foreign country.

11. Intel receives dividends from its domestic and its foreign subsidiaries. The dividends are paid to Intel or an intermediate subsidiary from the payor subsidiary corporation's current and or accumulated after-tax earnings.

12. For federal tax purposes, pursuant to IRC § 243, Intel is allowed a 100% deduction for dividends received from its domestic subsidiaries. Intel claimed and was allowed the 100% dividends received deduction pursuant to IRC § 243 for dividends received from its domestic subsidiaries.

13. Intel filed a consolidated U.S. corporation income tax return, Form 1120, with its affiliated group as defined in IRC § 1501.

14. For federal tax purposes, corporations are generally not allowed a deduction for dividends received from foreign subsidiaries when dividends received are derived from payor foreign subsidiaries' foreign business

activities. All of Intel's foreign subsidiaries have only foreign business activities.

15. The federal government does not generally tax the earnings of foreign subsidiaries. Such earnings may be taxed by the foreign host country in which the earnings are generated.

16. In the computation of its consolidated federal taxable income, Intel is generally required by the federal tax law to include in income certain amounts deemed to be received by it and its affiliated corporations from the foreign business activities of their respective foreign subsidiaries. These "deemed dividends" result from the application of IRC §§ 951, *et. seq.* and IRC §§ 1291, *et. seq.* Those sections, as applied to Intel, provide that income is deemed to be received by Intel from its foreign subsidiaries which are controlled foreign corporations under IRC § 957 or passive foreign investment companies (PFIC) under IRC § 1296. "Deemed dividend" income is Subpart F income and PFIC income.

17. Intel's Subpart F income consists of foreign base company income as defined in IRC § 954. Such income is deemed to have been distributed to Intel from the undistributed earnings and profits of Intel's foreign subsidiaries which are controlled foreign corporations under IRC § 957. If the income is later repatriated in the form of an actual dividend, Intel does not report that dividend income.

18. Like Subpart F income, Intel's PFIC income consists of income deemed to have been distributed to Intel from the undistributed earnings and profits of Intel's

foreign subsidiaries which are passive foreign investment companies.

19. Intel's foreign subsidiaries operate in foreign commerce and the flow of value between Intel and its foreign subsidiaries, including the dividends and deemed dividends received from its foreign subsidiaries constitutes foreign commerce.

20. Federal tax laws afford taxpayers such as Intel (in this case the Intel affiliated group) an election to either claim a credit for or to deduct the foreign taxes paid or accrued. Intel elected to claim a credit for foreign taxes paid or accrued.

21. When Intel receives an actual dividend from one of its foreign subsidiaries, the foreign host country has the right to subject Intel to taxation on the amount of the dividend received. When this right is exercised, it is usually accomplished through a withholding tax mechanism, whereby Intel's tax liability is paid over by the foreign subsidiary to the foreign country on behalf of Intel. The rate of tax imposed by the foreign country upon Intel is usually determined by a treaty between the United States and the foreign country. If there is no tax treaty, the tax rate is determined by the laws of the foreign country.

22. When Intel filed its CIT-1 returns with New Mexico it elected to use the separate entity reporting method as set forth in Regulation CIT 9:2 and its predecessors. Intel filed its returns in a manner consistent with its separate entity election. Regulation CIT 9:2, as it existed during the relevant tax years, allowed Intel to affirmatively elect, without the consent of the Department, to

change its reporting method to either a combination of unitary subsidiaries or to a federal consolidated group. Intel did not so elect.

23. For 1988, 1989, and 1990, New Mexico base income was federal taxable income as shown on line 30 of a taxpayer's federal Form 1120, with a deduction for IRC § 78 "gross-up", together with certain other adjustments not material to this case. For the 1991 and subsequent years, New Mexico base income consists of federal taxable income as shown on line 30 adjusted to add back net operating losses claimed under IRC § 172(a), interest received on state or local bonds issued by a state other than New Mexico, deduction of IRC § 78 "gross-up" and certain other adjustments not material to this case

24. Since Intel was a member of an affiliated group which filed a consolidated federal return, Intel was required to prepare and file with the Department a simulated federal income tax return. Intel did so.

25. In preparing its simulated federal income tax return, Intel, in accordance with federal tax law, deducted from income pursuant to IRC § 243, dividends it received from its domestic subsidiaries. It did not deduct dividends it received from its foreign subsidiaries.

26. On Intel's simulated federal income tax return and in Intel's consolidated federal return, dividends received by Intel from its domestic subsidiaries were deducted in full. Dividends, PFIC income and Subpart F income from Intel's foreign subsidiaries were not deductible in full or in part.

27. New Mexico does not allow a credit for foreign taxes paid but does allow a deduction for foreign taxes paid if such a deduction is claimed by a taxpayer in its federal income tax return in lieu of the foreign tax credit.

28. Intel filed its 1988, 1989 and 1990 New Mexico CIT-1 returns in accordance with New Mexico's tax scheme. Accordingly, for those years Intel included in the New Mexico tax base dividends received and PFIC income and Subpart F income deemed to be received from its foreign subsidiaries and it excluded from the New Mexico tax base dividends received from its domestic subsidiaries.

29. Intel's 1991 New Mexico CIT-1 return was filed after ***Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance***, 112 U.S. 2365 (1992) was decided. In its 1991 return, Intel excluded from apportionable income all dividends received and all PFIC income and Subpart F income deemed to be received from its foreign subsidiaries.

30. In its 1988 return, Intel reported New Mexico base income of $327,192,955. Included in the amount reported as New Mexico base income were dividends, PFIC income and Subpart F income received and deemed to be received from Intel's foreign subsidiaries in the following amounts:

Dividends from foreign corporations (1120 Schedule C, line 13)	$ 99,127,699.00
Subpart F income (1120 Schedule C, line 14)	$ 42,107,455.00
PFIC income (1120, Line 10)	$ 39,636,743.00
Total	$180,871,897.00

31. In its 1989 return, Intel reported New Mexico base income of $207,622,187. Included in the amount reported as New Mexico base income were dividends and Subpart income received and deemed to be received from Intel's foreign subsidiaries in the following amounts:

Dividends from foreign corporations (1120 Schedule C, line 13)	$ 28,547,285.00
Subpart F income (1120 Schedule C, line 14)	$ 9,379,708.00
Total	$ 37,926,933.00

32. In its 1990 return, Intel reported New mexico base income of $680,171,975. Included in the amount reported as New mexico base income were dividends, PFIC income and Subpart F income received and deemed to be received from Intel's foreign subsidiaries in the following amounts:

Dividends from foreign corporations (1120 Schedule C, line 13)	$ 67,505,079.00
PFIC Income (1120 Schedule C, line 14)	$ 53,434,727.00
Subpart F Income (1120 Schedule C, line 14)	$ 32,678,169.00
Total	$ 153,618,065.00

33. Intel paid the following amounts of New Mexico income tax for the following years:

1988	$ 1,415,825.00
1989	$ 1,126,732.00
1990	$ 4,340,925.00
Total	$ 6,883,482.00

34. On September 15, 1992, Intel timely filed its 1991 New Mexico CIT-1 return. In that return, Intel deducted from New Mexico base income $60,863,895 of dividends received and PFIC income and Subpart F income deemed to be received from its foreign subsidiaries. These deductions were expressly disclosed in a statement attached to the 1991 return. the deducted dividends consisted of $29,095,614 in actual dividends paid by foreign subsidiaries and $31,768,281 in deemed Subpart F and PFIC income received and deemed to be received.

35. Intel's 1991 return reported a New Mexico tax liability of $4,078,182. Intel had made tentative and/or estimated New Mexico income tax payments for 1991 of $5,001,468. Accordingly, Intel's 1991 return claimed a refund of $923,286.

36. On December 28, 1992, in accordance with § 7-1-26 NMSA 1978, Intel timely filed amended New Mexico CIT-1 returns for 1988, 1989 and 1990 seeking refunds of overpaid New Mexico corporate income taxes in the following amounts:

1988	$ 878,907.00
1989	$ 217,394.00
1990	$ 1,021,764.00
Total	$ 2,118,065.00

37. By letters dated February 4, 1993, the Department denied in full Intel's refund claims for 1988, 1989 and 1990.

38. By a letter dated February 4, 1993, the Department denied in part Intel's refund claim for 1991, granting a refund of $410,390.79, rather than the refund claimed of $923,286. The amount of the refund denied was $512,895.21, consisting of $484,871 attributable to the Department's disallowance of Intel's claimed deduction of $60,863,895 for actual dividends received and PFIC income and Subpart F income deemed received from Intel's foreign subsidiaries and $28,025.21 in asserted penalty and interest. The Department subsequently granted an additional refund of $28,024.21, plus interest, representing the amount of penalty and interest included in the original refund denial.

39. On March 29, 1993, Intel timely protested the denial of its refund claims and requested a formal administrative hearing in accordance with § 7-1-24 NMSA 1978. Intel timely requested and received a proper extension of time from the Department within which to file its protest.

40. On March 17, 1994 the Department adopted Regulation UDI 19:10, which adopts the "Detroit formula" as a form of factor relief to be applied to separate entity taxpayers in order to alleviate any discrimination arising from the disparate treatment of domestic and foreign dividends for such separate entity filers. The Regulation is effective retroactively to tax years beginning on or after January 1, 1988.

41. The Department has agreed in this case that the Detroit formula as expressed in Regulation UDI 19:10 should be applied to Intel's deemed foreign dividend income as well as its actual foreign dividend income.

42. Where dividend income from a foreign subsidiary is included in the apportionable tax base of a domestic parent corporation, the Detroit formula operates to adjust the apportionment formula by including in the denominators of the parent corporation's property, payroll and sales factors a percentage of the property, payroll and sales of the dividend generating foreign subsidiary. The percentage of the foreign subsidiary's property, payroll and sales to be included is the ratio that the net dividends received from such subsidiary bears to the subsidiary's net profits.

43. The overall effect of applying Regulation UDI 19:10 to Intel or similarly situated taxpayers is to reduce the apportionment figure to be applied to New Mexico base income, thereby reducing the amount of income tax due.

44. The specific effect of the application of Regulation UDI 19:10 to Intel's apportionment factor for the tax years at issue is as follows:

	Apportionment Factor As Reported	Apportionment Factor After Application of UDI 19:10
1988	6.396%	5.916%
1989	7.5441%	.1936%
1990	8.755%	7.9794%
1991	10.4822%	9.7122%

45. As compared to the exclusion of Intel's foreign dividend, Subpart F and PFIC income from New Mexico taxable income, the application of UDI 19:10 to Intel for the tax years in issue results in higher corporation income taxes owing to New Mexico, as shown below:

	Tax if foreign dividend, Subpart F and PFIC income is excluded	Tax if Regulation UDI 19:10 is applied
1988	$ 741,258.00	$ 1,308,024.00
1989	$ 909,227.00	$ 1,073,407.00
1990	$3,318,732.00	$ 3,956,320.00
1991	$4,108,132.00	$ 4,255,611.00

46. For separate corporate entity filers with foreign dividend and deemed dividend income, the application of Regulation UDI 19:10 may result in higher, the same, or lower New Mexico corporation income taxes than would result from the exclusion of the taxpayer's foreign dividend and deemed dividend income. The comparative effect of the application of Regulation UDI 19:10 depends upon the relative efficiencies of the taxpayer's foreign and domestic operations and does not inherently treat the foreign source income of the taxpayer less favorably than its domestic source income.

47. By calculating New Mexico base income for separate corporate entity filers based upon Line 30 of federal Form 1120, New Mexico's scheme for the taxation of dividend income received from domestic and foreign subsidiary corporations of separate corporate entity filers is indistinguishable in any material or meaningful way from the Iowa corporate income tax scheme found by the United States Supreme Court in ***Kraft General Foods, Inc. v. Iowa Department of Revenue*** to facially discriminate against foreign commerce in violation of the Commerce Clause of the United States Constitution.

48. One way of eliminating the discrimination against Intel's foreign commerce based income is to exclude Intel's foreign dividend and deemed dividend income from New Mexico taxable income.

49. The differential treatment of foreign and domestic source dividend income for separate corporate entity filers in New Mexico provides a basis for the Department to offer an adjustment of factors under Section 7-4-19 NMSA 1978.

50. As an employee benefit, Intel has adopted a dependent care assistance program (the "DCAP" Plan). The DCAP Plan has two parts. One part is a resource and referral service to assist employees in finding day care programs for their dependent children. The other part is a salary reduction payroll program by which employees may shelter from income tax a portion of their salary and then use the tax sheltered salary to pay for dependent care expenses.

51. Enrollment in the DCAP plan is voluntary by Intel employees. Intel employees may enroll in the DCAP

Plan on an annual basis. Upon enrollment, an employee must designate, within certain limitations, a specific amount of salary to be paid into the DCAP Plan. The designated amount cannot be changed except in very limited circumstances. Intel pays the designated salary into the plan, rather than to the employee. The amounts paid by Intel into the DCAP Plan are excluded from the employees gross income pursuant to IRC § 129. After incurring dependent care expenses, the employee submits evidence of those expenses to the DCAP Plan and obtains reimbursement of those expenses from the DCAP Plan in accordance with the terms of the DCAP Plan.

52. Any funds placed in the DCAP Plan by Intel on behalf of a participating employee which are in excess of the reimbursed expenses received by the employee during the plan year remain the funds of the DCAP Plan.

53. In 1991, Intel claimed a $30,000 corporate-supported child care credit pursuant to Section 7-2A-14 NMSA 1978.

54. Intel's claimed corporate-supported child care credit was audited by the Department's auditor, Charles Langston. As a result of the audit, the Department disallowed the credit to the extent of $22,667.

55. The portion of the child care credit that was disallowed related only to the salary reduction component. There were not any adjustments made to the credit that Intel claimed with respect to the referral service component.

56. On March 22, 1994, the Department mailed Assessment No. 1775546 to Intel, assessing $22,667 in

corporate income tax, penalty in the amount of $2,266.70, and interest in the amount of $7,083.44, based upon the Department's disallowance of a portion of Intel's claimed child support credit for tax year 1991.

57. On March 25, 1993 Intel filed a written protest, pursuant to § 7-1-24 NMSA 1978 to Assessment No. 1775546.

58. The Department has agreed that since Intel has a refund coming for 1991, that the penalty and interest portion of Assessment No. 1775546 should be abated.

59. Intel is a full accrual taxpayer.

60. For financial accounting and reporting purposes and for income tax purposes, expenses related to the DCAP Plan are accounted for by Intel as an employee benefit expense.

61. For 1991, Intel's United States and New Mexico income tax returns treated the $22,667 of expenses related to the DCAP Plan as accrued and fully paid.

DISCUSSION

This protest presents two matters for determination. The first and most complex of the matters concerns whether a portion of New Mexico's corporation income tax scheme discriminates against foreign commerce and if so, the remedy for such discrimination, (the foreign commerce issue). The second matter concerns Intel's eligibility for the credit, provided at § 7-2A-14 NMSA 1978 for corporate supported child care, (the child care credit issue).

THE FOREIGN COMMERCE ISSUE

This issue arises as a result of the United States Supreme Court's decision in ***Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance,*** 505 U.S. ___, 112 S.Ct. 2365 (1992), hereinafter, ***Kraft***. In that decision, the Supreme Court ruled that Iowa's corporate income tax scheme, which uses the federal definition of net income as a starting point in calculating Iowa taxable income, facially discriminates against foreign commerce in violation of the Foreign Commerce Clause, U.S. Const., Art. I, Section 8. The basis for the Court's decision is that in computing net income for federal tax purposes, the Internal Revenue Code, Section 243, provides a deduction for dividends received from domestic subsidiaries. This is done because the earnings of the domestic subsidiaries themselves are fully taxable at the federal level and the deduction avoids a second federal tax on those earnings. ***Kraft,*** 112 S.Ct. at 2367. The federal government does not tax the earnings of foreign subsidiaries, so there is no concomitant deduction in the Internal Revenue Code for the dividends received from foreign subsidiaries. There is a credit provided, however, to the parent corporation for the foreign taxes paid on the dividends and on the underlying foreign earnings. IRC Sections 901 and 902. This credit is intended to mitigate the multiple taxation of corporate earnings. ***Kraft,*** 112 S.Ct. at 2367. Iowa, by following the federal definition of net income in arriving at income subject to taxation in Iowa, included the dividends received by Iowa corporations from their foreign subsidiaries, and excluded the dividends received by those corporations from their domestic subsidiaries. The

Court ruled that this scheme violated the Foreign Commerce Clause.

Intel argues that the application of *Kraft* to the filing methodology it has elected in New Mexico compels an identical conclusion and entitles it to the refunds which it has claimed.

Before examining Intel's contentions, a review of the New Mexico corporation income tax scheme as it relates to the taxation of income of multistate and multinational corporations will provide a context for examining the complex issues raised by this case.

Background

Like Iowa, New Mexico uses federal taxable income as shown on line 30 of a taxpayer's federal corporate income tax return as the starting point (New Mexico base income) for calculating corporate income taxes. New Mexico allows corporate taxpayers to elect among four different reporting methods. Regulation CIT 9:2 provides that in filing its initial New Mexico corporate income tax return, a taxpayer may use any one of four reporting methods:

1. separate accounting
2. separate corporate entity
3. combination of unitary corporations
4. federal consolidated group.

The regulation further provides that in succeeding years, the taxpayer may elect to file on any basis with a higher ranking on the above numbered list, without prior permission of the Department. However, taxpayers will not

be allowed to choose a lower ranked method without first obtaining written permission from the Department.

In order to provide a context for understanding the various allowable filing methods and their relationship to the Foreign Commerce Clause issues raised by this case, a review of the interrelationship between the Foreign Commerce Clause, the Due Process Clause and the state's ability to tax income generated in foreign commerce will be reviewed. Additionally, New Mexico's statutory method for apportioning income among multistate and multinational corporate entities, the Uniform Distribution of Income for Tax Purposes Act (UDITPA), Chapter 7 Article 4 NMSA 1978, will also be discussed.

It is fundamental under both the Due Process and Commerce Clauses of the Constitution that a state may not, when imposing an income based tax, tax value earned outside of its borders. ***See, Asarco, Inc. v. Idaho State Tax Commission,*** 458 U.S. 307 (1982). When dealing with income that has been earned by a multistate and multinational taxpayer, determining what income has been earned by that taxpayer within a particular state can be extremely complicated and has generated a significant amount of constitutional litigation in the U.S. Supreme Court. ***See, e.g., Asarco, Container Corporation of America v. Franchise Tax Board,*** 463 U.S. 159 (1983); ***Mobil Oil Corporation v. Comm'r of Taxes of Vermont,*** 445 U.S. 425 (1980); ***F.W. Woolworth co. V. Taxation and Revenue Department,*** 458 U.S. 354 (1982); ***Exxon Corp. v. Wisconsin Department of Revenue,*** 447 U.S. 207 (1980); ***Moorman Manufacturing Co. v. Baer,*** 437 U.S. 267 (1978); and many others. Because of the difficulty of precisely measuring a state's properly apportioned share of a multijurisdictional

taxpayer's income, the Supreme Court has long held that the Constitution imposes no single formula on the states, ***Wisconsin v. J.C. Penney,*** 311 U.S. 435, 445 (1940), and has placed upon a taxpayer challenging a state's formula, the burden of showing by clear and cogent evidence that a state tax results in the taxation of extraterritorial values. ***Exxon Corporation, supra,*** 447 U.S. at 221. Historically, states attempted to account for their share of taxable income based upon systems of separate accounting whereby a company's income earned within the geographical boundaries of the state was determined based on formal corporate entities or on an attempt to segregate transactions conducted within the state. This methodology, called separate accounting, has fallen into disfavor because it was subject to manipulation and imprecision and, significantly, either ignored or failed to capture the many subtle and often unquantifiable transfers of value that take place among the components of a large, complex enterprise. ***See, generally, Mobil Oil Corp.,*** 445 U.S. at 438-439. As a result of the inadequacy of the separate accounting concept, the unitary business concept evolved. The unitary business principle generally disregards territorial boundaries and corporate structure issues. The unitary concept requires viewing a business enterprise as a single unit irrespective of whether the enterprise crosses geographic boundaries or its business is conducted through separate corporate entities. Once the scope of a unitary business is defined, the taxable income of the total unitary enterprise is determined and an apportionment formula is applied to approximate the unitary business income which is reasonably related to

the business' activities conducted within the taxing jurisdiction based upon various objective measures of the taxpayer's activities both within and without the taxing jurisdiction. The Supreme Court long ago upheld the constitutionality of the basic unitary business concept. ***See, e.g., Hans Rees' Sons, Inc. v. North Carolina, ex rel, Maxwell,*** 283 U.S. 123 (1931); ***Bass, Ratcliff and Gretson, Ltd. v. State Tax Commission,*** 266 U.S. 271 (1924); ***Underwood Typewriter Company v Chamberlain,*** 254 U.S. 113 (1920). More recently, the Court has noted that "the linchpin of apportionability in the field of state income taxation is the unitary business principle." ***Mobil Oil Corporation,*** 445 U.S. at 439. In other words, it is the unitary business principle which provides the constitutional basis for the use of an apportionment formula by the states to apportion to the states their appropriate share of corporate income.

Like many other states, New Mexico has adopted the Uniform Division of Income for Tax Purposes Act, "UDITPA", Chapter 7, Article 4 NMSA 1978 for determining the portion of income which is attributable to New Mexico for corporations having income from both within and without New Mexico. UDITPA provides a three factor apportionment formula for arriving at the portion of income subject to New Mexico tax. The UDITPA formula requires the creation of three fractions: 1) the value of a corporation's property in a given state (the property numerator) divided by its property everywhere (the property denominator); 2) the corporation's payroll in the state (the payroll numerator) divided by its payroll everywhere (the payroll denominator); 3) and the taxpayer's sales in the state (the sales numerator) divided by its

sales everywhere (the sales denominator). These three fractions are then added together and divided by three to arrive at a fraction or multiplier which is applied to the corporation's total apportionable income to arrive at the portion which can be taxed by the given state.

As noted earlier in this discussion, by regulation, the Department allows corporate income taxpayers to elect among four different reporting methods. These are described in the Department's Corporate Income Tax Publication 102, of which judicial notice is taken. New Mexico allows two versions of separate accounting. The first, simply called separate accounting, allows corporate taxpayers to report income as if its business activities were conducted by a distinct and separate entity which operated solely within New Mexico. Thus, only income generated and expenses incurred from business activities conducted within New Mexico are considered when calculating New Mexico taxable income. This option is only available to corporations beginning business in New Mexico prior to January 1, 1991 and is limited to five consecutive years, beginning with the first year the corporation does business in New Mexico. Section 7-2A-8(A)(4) NMSA 1978. The second version of separate accounting reporting is called separate corporate entity. Under this methodology, although a corporation may be part of a federal consolidated group, it is allowed to file separately from the other members of the group. The entire income of the corporation is reported to New Mexico, and then the three factor UDITPA formula is applied to apportion the income among New Mexico and the other states in which the corporation operates. Only the

income of the reporting corporation, and not of its subsidiaries or affiliates is subject to apportionment. However, the income the corporate taxpayer actually receives from its subsidiaries and affiliates in the form of dividends, interest, royalties is considered to be income of the corporate taxpayer, subject to allocation and apportionment. The third reporting method is called combination of unitary domestic corporations. Under this method, the combined income of all members[1] of the unitary business is reported to New Mexico and then allocated or apportioned to New Mexico. Inter-company transfers, such as dividends, are excluded from consideration as income, since the total income of the subsidiary corporation paying the dividend is already included in the income subject to allocation and apportionment. Only domestic corporate members of the unitary group, however, can be included in the group for reporting purposes. Foreign subsidiaries and affiliates are excluded from the reporting group even if they are part of the unitary business group.[2] The fourth allowable filing method is called federal consolidated. Under this method, a corporation filing a federal consolidated return may elect to report the income of all of the affiliated corporations included on

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[1] All members of the unitary business are included in the reporting group, regardless of whether they engage in business in the state. Application of the three factor apportionment factor will operate to segregate the non-New Mexico income from the New Mexico based income of the unitary group, and apportion only the New Mexico based income to the state.

[2] When the foreign affiliates and subsidiaries are included in the unitary reporting group, this reporting method is called world-wide combined reporting.

the federal return. The three factor formula is then applied to the income of the consolidated group to apportion the appropriate share to New Mexico. The consolidated group may include members which may be non-unitary. As with domestic combined reporting, inter-company transfers are eliminated to avoid the double counting of income.

DOES THE OPERATION OF NEW MEXICO'S INCOME TAX DISCRIMINATE AGAINST FOREIGN COMMERCE?

Intel has consistently elected to file corporation income taxes in New Mexico using the separate corporate entity method of filing. There can be no dispute that under New Mexico's separate corporate entity method of filing, as applied to corporations with dividend income from both foreign and domestic subsidiaries, by basing the definition of New Mexico base income on line 30 of federal form 1120, that foreign dividend income is included in base income and domestic dividend income is excluded. This is identical to the treatment of the dividend income of Kraft General Foods, Inc. by Iowa, a treatment which the Court ruled amounted to facial discrimination against foreign commerce in contravention of the Foreign Commerce Clause. ***Kraft,*** 112 S.Ct. at 2372. It is thus clear, that when applied to corporations with dividend income from both domestic subsidiaries and foreign subsidiaries and affiliates, New Mexico's separate entity reporting method operates in the same fatally discriminatory manner against foreign commerce.

THE QUESTION OF REMEDIES

The Department asserts that Intel is entitled to no refund of taxes even if New Mexico's separate entity

filing method is fatally discriminatory against foreign commerce for those taxpayers with foreign dividend income because of the availability of other filing methods which Intel could have elected which do not operate to discriminate against foreign commerce. Specifically, the Department relies on the availability of domestic combined reporting which it argues does not operate to discriminate against foreign commerce. Assuming, but not deciding, that the Department is correct in its argument that New Mexico's domestic combined reporting method would not discriminate against foreign commerce for those taxpayers with foreign dividend income[3], nonetheless, Intel has exercised the right given it by the Secretary[4] in Regulation CIT 9:2 to file under the separate corporate entity filing method. Having made a valid election of filing methods, Intel is entitled to have that filing

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[3] I have previously considered this issue in a closely related matter, presently on appeal to the Court of Appeals. The analysis of this issue is extremely involved and unnecessary to the resolution of the issues in this case given my conclusion, *infra*. that the availability of another nondiscriminatory filing method does not remedy the discrimination complained of under the separate entity filing method.

[4] It is interesting to note that there is specific statutory authority for the other three filing methods. Separate accounting is authorized in § 7-2A-8(A)(4) NMSA 1978. Domestic combined reporting is authorized in § 7-2(A)-8.3 NMSA 1978. Federal consolidated reporting is authorized in Section 7-2(A)-8.4 NMSA 1978. While there is no specific statutory authority for separate corporate entity reporting, § 7-2(A)-9(B) NMSA 1978 grants the Secretary of the Department the authority to prescribe the form and content of corporate tax returns, which the Secretary has exercised by promulgating Regulation CIT 9:2.

method applied to it in a constitutional manner. The Department has cited to ***Sutin, Thayer and Browne v. Revenue Division,*** 104 NM 633, 725 P.2d 883 (Ct. App. 1984) and ***Taxation and Revenue Department v. F. W. Woolworth,*** 95 N.M. 519, 624 P.2d 28 (1981) ***rev'd on other grounds,*** 458 U.S. 354 (1982) as providing analogous situations where the courts have held that a taxpayer could not complain about the loss of a state tax deduction which occurs as a consequence of a choice made for federal purposes. I do not find those cases persuasive in this instance, however, because they did not involve the right of a taxpayer to have tax statutes applied in a constitutional manner, which is a far weightier consideration than the equitable arguments raised in those cases.

Additionally, since Intel filed its returns in compliance with an election granted to it by regulation, the Department is estopped by the provisions of Sectopm [sic] 7-1-60 from denying the benefit of that filing methodology, including the implicit right to lawful application of that authorized filing methodology.

Intel argues that a full refund of taxes paid in excess of that which would be paid if its foreign dividend and deemed dividend income was excluded from the New Mexico tax base is the exclusive remedy for illegally collected taxes. For authority, Intel cites to a Santa Fe County unpublished district court opinion, ***Burns, et. al. v. State of New Mexico ex. rel. Taxation and Revenue Department,*** Santa Fe County Cause no. SF 89-1314(C), provisions of the Tax Administration Act, and ***Hackman v. Director of Revenue,*** 771 S.W.2d 77 (Mo. 1989) ***cert. denied,*** 493 U.S. 1019 (1990), the Missouri decision upon

which the ***Burns*** decision relied. In response, the Department relies upon ***McKesson Corporation v. Division of Alcoholic Beverages and Tobacco,*** 496 U.S. 18, 110 S.Ct. 2238, 110 L.Ed.2d 17 (1990), where the Court held that under the Due Process Clause, (which requires a fully adequate post-deprivation procedure), "a State found to have imposed an impermissible discriminatory tax retains flexibility in responding to this determination." ***Id.*** at 2252.

It is clear from a reading of ***McKesson,*** that due process only requires that the state provide a remedy by which, "the resultant tax actually assessed during the contested tax period reflects a scheme that does not discriminate against interstate [foreign, in this instance] commerce." *Id.* at 2252. ***Accord., Associated Industries v. Lohman,*** 114 S. Ct. 1815, 62 U.S.L.W. 4391 (1994). Thus, there is no federal mandate that Intel be given a refund, if an alternative remedy is offered which can meet both Foreign Commerce Clause and Due Process Clause concerns. For Intel argument to prevail, it must rest on an independent state law basis.

I am not persuaded that one exists. A review of the relevant provisions of the Tax Administration Act concerning refunds of tax overpayments, Sections 7-1-3(I), 7-1-26 and 7-1-29 NMSA 1978 reveals only permissive language concerning the application for and the granting of tax refunds. New Mexico has no comparable provision to Missouri, upon which the decision in the *Hackman* case was premised, which mandates the refund of overpaid taxes.

The examination of the language of the relevant New Mexico statutes lends further support for the conclusion that New Mexico statutes do not provide for a full refund as an exclusive remedy. Section 7-1-3(I) defines an "overpayment" as "any amount paid . . . in excess of tax due. . . . " Similarly, Section 7-1-26 provides for the refund of any tax "paid in excess" of that for which the taxpayer was liable, and Section 7-1-29 provides for the refund of any tax "erroneously paid". Thus, the determination of the refund due is based upon determining what was paid in excess of what was owed. To determine the amount owed, reference is made to Section 7-2A-2(I)(3), the definition of "net income" which excludes "other amounts that the state is prohibited from taxing because of the laws or constitution of this state or the United States". Reading these sections together, it is clear that in the context of an income tax which unconstitutionally discriminates, the taxpayer is entitled to a refund of only those amounts which could not otherwise be constitutionally subject to tax.

Additionally, the issue being addressed by the District Court in the ***Burns*** case was not whether a refund of tax was the only appropriate remedy among several being offered, but whether they were entitled to retroactive as opposed to prospective relief from an unconstitutional tax. Retroactivity of relief is not an issue herein. The Department has conceded that any determination of unconstitutionality should be given retroactive application to this taxpayer for the years at issue. I find nothing in the relevant tax statutes, or in the authorities presented which persuades me to conclude that the legislature

intended to circumscribe the state's available remedies for discriminatory taxation to a refund of taxes.

DOES UDI 19:10 PROVIDE AN ADEQUATE REMEDY TO THE DISCRIMINATION AGAINST FOREIGN COMMERCE?

The Department has promulgated Regulation UDI 19:10, retroactively effective to the tax years at issue herein, which adopts a form of factor relief known as the "Detroit formula"[5] to remedy the facially discriminatory application of the separate corporate entity filing method to taxpayers with foreign dividend income. For such taxpayers, the formula operates to modify the apportionment formula by including in the denominators of the parent corporation's property, payroll and sales factors a percentage of the property, payroll and sales of the dividend generating foreign subsidiary. The percentage of the foreign subsidiary's property, payroll and sales to be included is the ratio that the net dividends received from such subsidiary bears to the subsidiary's net profits. The overall effect of applying Regulation UDI 19:10 to Intel or similarly situated separate entity filers with foreign dividend income is to reduce the apportionment factor to be applied to New Mexico base income, thereby reducing the tax due.

Before examining the application of the Department's regulation, it is useful to review the Court's holding in

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[5] The Detroit formula is named after the agreement reached between the city of Detroit and Ford Motor Company regarding the tax treatment of Ford's foreign dividends under the Detroit income tax.

Kraft. The Court did not create a rule that said that states could never consider foreign source dividend income in determining the portion of a multijurisdictional corporation's income it could tax. The Court left untouched the long line of cases upholding the taxation of foreign dividend income. *See, Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980). Rather, the Court ruled that Iowa's taxing scheme discriminated against the taxpayer's foreign commerce. Thus, in evaluating the adequacy of the Department's proposed remedy, Regulation UDI 19:10, the issue is whether after the application of the regulation, the tax collected in no respect impermissibly discriminates against foreign commerce.

The first issue to be determined in evaluating the adequacy of the Detroit formula remedy offered by the Department is whether fair apportionment can remedy discrimination. The Department contends that it does, by assuring that New Mexico is only taxing income, which, as determined by a fair apportionment formula, is sufficiently related to a taxpayer's activities in New Mexico. The Department argues that the apportionment formula has the effect of eliminating any of Intel's foreign source dividend income from the New Mexico tax base.

Intel cites to *Westinghouse Electric Corporation v. Tully*, 466 U.S.388, 398-399; 104 S.Ct. 1856, 1862-1863 (1984) for the proposition that fair apportionment cannot cure a facially discriminatory statute. This case involved a Commerce Clause discrimination challenge to the manner in which New York allows corporations a tax credit upon accumulated income of a subsidiary Domestic International Sales Corporation (DISC). New York used the three factor UDITPA apportionment formula to apportion

its share of the accumulated DISC income to the state. The Court found that the constitutionality of New York's apportionment formula was a different issue, which was irrelevant to the issue of discrimination before the Court. As stated by the Court, " 'Fairly apportioned' and 'non-discriminatory' are not synonymous terms." ***Id.*** 466 U.S. at 399, 104 S.Ct. at 1863.

Of course, apportionment and non-discrimination are separate concepts. If they weren't, there would only need be three parts to the traditional four part test for constitutionality first set out in the seminal case, ***Complete Auto Transit v. Brady,*** 430 U.S. 274, 279 (1977). Apportionment assures that the taxing jurisdiction is only taxing income which is sufficiently related to the taxpayer's activities within the state. Discrimination involves an examination of whether foreign versus domestic or interstate versus intrastate commerce are unequally burdened.[6] I am not convinced that the inclusion of foreign factors under the Detroit formula totally eliminates all foreign based dividend income from the tax base. As just noted, it only assures that the income which is being taxed is sufficiently related to the taxpayer's activities in this state. If you look at the situation presented here, application of the Detroit formula to a separate entity reporting taxpayer, we have a truly hybrid system. We have added some degree of formulary apportionment to a separate

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[6] While fair apportionment and discrimination are separate concepts which require independent analysis under the Commerce Clause, this does not preclude the possibility that the **effect** of the application of an apportionment formula may offset any potential discriminatory effect of other provisions of a tax structure, as will be seen below.

accounting method of reporting. It is widely acknowledged that separate accounting fails to capture the many subtle and often unquantifiable transfers of value that take place among the components of a large, multi-jurisdictional, integrated enterprise. ***See, Mobil Oil Corp.***, 445 U.S. 438-439. Three factor formulary apportionment has a been widely accepted as a better system for capturing appropriate values for taxation purposes. Thus, under separate entity filing, what we have is a system which starts with a tax base which may not accurately reflect Intel's true New Mexico income picture to begin with, and we attempt to refine the focus by applying what is widely acknowledged to be a fair apportionment formula to it. Given this situation, I believe that it is impossible to say with certainty that no single dollar of foreign dividend income remains in the tax base.

This brings us to Intel's "defective tax base" issue. Intel argues that apportionment cannot render constitutional a discriminatorily defective tax base. Intel's Post-Hearing Brief, p. 33. I have found no reference in the entire Supreme Court jurisprudence on discrimination under the Commerce Clause which speaks of a constitutionally defective tax base. There is lots of jurisprudence about discriminatory taxes. Those cases examine the entire taxing scheme, not just the tax base itself before credits, adjustments, apportionment, etc. are applied, to determine if discrimination exists. ***See, Halliburton Oil Well Cementing Company v. Reily,*** 373 U.S. 64, 69-70, 83 S.Ct. 1201, 1204 (1963), and cases cited therein. Lest there be any doubt that the Court in ***Kraft*** considered this to be the appropriate standard, it stated that:

> We have no reason to doubt the assertion of the United States that "[i]n evaluating the alleged facial discrimination effected by the Iowa tax, it is not proper to ignore the operation of the other provisions of the *same* statute." (quoting from the Brief for the United States).

Id. 112 S.Ct. at 2371. Thus, it is immaterial whether the calculation of the tax base itself operates in a manner which results in discriminatory treatment of the portion of it coming from foreign commerce. The relevant inquiry is whether the operation of the tax, (in this case, the application of the separate entity filing method with the foreign factors included in the parent company's factors under the Detroit formula) as a whole, discriminates against foreign commerce.

Supreme Court precedent concerning discrimination under the Commerce Clause categorizes the discrimination in three ways:

> a tax may violate the Commerce Clause if it is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce. (Citing Smith, State Discriminations against Interstate Commerce, 74 Calif.L.Rev. 1203, 1239 (1986)).

Amerada Hess Corp. V. Director, Division of Taxation, 490 U.S. 66, 75, (1989). Facial discrimination is described in the law review article cited above:

> When a regulation is discriminatory on its face, the very terms of the regulation deal unequally with people inside and outside the state. There is no need to resort to any

> additional information – except perhaps matters known to everyone – to discern that the state has given an advantage to insiders.

Smith, supra, at 1239. Although the article refers to discriminations against interstate commerce, the classifications of discrimination should equally apply to foreign commerce. Conoco's challenge to the Department's corporate tax scheme for separate entity filers alleges facial discrimination, on the basis that the differential treatment of foreign as opposed to domestic dividend income is indistinguishable from Iowa's tax treatment of the same, which the Court found to be facially discriminatory in *Kraft*. Intel challenges the Department's proposed remedy, the Detroit formula, on the same basis, facial discrimination, arguing that apportionment under the Detroit formula will not remedy a constitutionally defective tax base.

Before examining the evidence on the issue of discrimination, it may be helpful to review the standard of proof upon those making a facial challenge to the constitutionality of a taxing scheme. As noted by Chief Justice Rehnquist in his dissent in *Kraft*:

> The burden on one making a facial challenge to the constitutionality of a statute is heavy; the litigant must show that "no set of circumstances exists under which the Act would be valid. The fact that [the tax] might operate unconstitutionally under some conceivable set of circumstances is insufficient to render it wholly invalid. *United States v. Salerno*, 481 U.S. 739, 745, 107 S.Ct. 2095, 2100, 95 L.Ed.2d 697 (1987).

Id., 112 S.Ct at 2372.

Turning to the issue of discrimination, Intel's proof of discrimination essentially boils down to a showing that, even after the application of Regulation UDI 19:10, it will pay more taxes than it would if all foreign dividend income is excluded. ***See,*** Report of John J. Cronin, Taxpayer's Exh. H.[7] Mr. Cronin, an expert in taxation, also questioned whether the application of the Detroit formula could really fairly apportion foreign based income because of such factors as inconsistencies in accounting and tax reporting procedures in various foreign countries and the fact that dividends do not necessarily correspond to real income because they may represent cumulative earnings rather than real earnings during any given tax period. Intel also presented the testimony of Dr. Ashwinpaul Sondhi, an expert in finance and accounting, who found basis to criticize the Detroit formula because it applies to dividends which are after tax earnings, as opposed to earnings ***per se***, and because he believed that the causal relationship between the factors by which income is generated (property, payroll and sales) and income may vary between domestic and foreign operations.[8] The difficulty of finding a formula which perfectly

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[7] Although Mr. Cronin's report and testimony was couched in terms of "effective tax rates", whereby he concluded that the application of UDI 19:10 resulted in a higher effective tax rate being imposed upon Intel than if foreign dividends are excluded, the net result of the analysis is that Intel pays more tax under the regulation than with dividend exclusion.

[8] Interestingly, Dr. Sondhi testified that if there is a differential in income generating efficiencies between an in-state operation and an out-of-state operation, then the application of the standard apportionment formula to the income from those operations would discriminate against the

attributes the income of complex multistate and multinational taxpayers has been likened to slicing a shadow and has generated significant constitutional litigation in the Supreme Court litigation over the years. *See,* cases cited at p. 16, ***supra.*** The Detroit formula is merely an extension of the generally accepted three factor UDITPA formula to foreign source income, by bringing into consideration the factors of the foreign operations generating the income as well as the income itself. The criticisms posed by Intel's experts of the application of the Detroit formula amounted to little more than nitpicking at the application of a formula, which has been widely accepted in the jurisprudence in this area as a reasonable formula for proper attribution of income to a taxing jurisdiction. If an apportionment formula properly attributes values to a taxing jurisdiction, then only income based in that jurisdiction is being subjected to tax. Formulary apportionment also recognizes that with a highly integrated multinational corporation, a foreign dividend does not necessarily represent income earned exclusively in foreign commerce, but may also represent the income generating capacity of the unitary corporation's operations elsewhere. Given the high degree of integration between Intel's foreign and domestic operations, formulary apportionment is the most reasonable way to measure the subtle and difficult to measure transfers of value

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out-of-state commerce. (Transcript of Proceedings, pp. 252-253). This testimony reveals that Dr. Sondhi does not understand the legal concept of discrimination against interstate or foreign commerce as applied by the courts, since the differential treatment results from factors other than the location of the commerce, itself.

which generate the income subject to tax. Thus, the mere demonstration that the application of the Detroit formula to Intel does not result in as low a tax as the exclusion of foreign dividends does not necessarily demonstrate that foreign source income is the subject of discrimination.

The Department presented the reports of two expert witnesses in economics, Dr. Al Maury, and Dr. Steven Sheffrin. The essence of Dr. Sheffrin's report is that if New Mexico gave factor relief under the Detroit formula, that this would result in New Mexico only taxing income earned in New Mexico and, thus, it would not be taxing Intel's foreign dividend income. Dr. Maury's report demonstrated the application of the Detroit formula to taxpayers with foreign dividend income under various scenarios and compared the tax due to what would be due with foreign dividend exclusion. The report demonstrates that in comparing the tax effect of the application of the Detroit formula versus exclusion of foreign dividend income for separate entity filers, the application of the Detroit formula can result in higher, identical or lower taxes than the exclusion of foreign dividend income, depending upon the relative efficiencies of a taxpayer's foreign and domestic operations. Efficiency is a function of the comparative profitability of the operations when compared to the resources needed to produce such income. Dr. Maury's report demonstrated that when a taxpayer's foreign operations are more efficient than its domestic operations, that the application of the Detroit formula results in higher New Mexico taxes than the exclusion of foreign dividend income. Where the efficiencies are the same, there is no differential tax effect. Where the foreign operations are less efficient than a taxpayer's

domestic operations, however, the application of the Detroit formula results in a lower New Mexico taxes than would result from foreign dividend exclusion.

When asked to comment upon this last scenario, Intel's witness, Jack Cronin, could not imagine that such a scenario would ever exist. It does not seem unreasonable to this decision maker, however, that there could be differential efficiencies between foreign and domestic operations, given the differential pay scales, costs of materials, energy costs, real estate costs, and other factors which may differ between domestic and foreign business locations.

In weighing the evidence concerning discrimination, Intel's showing that it will pay more taxes under Regulation UDI 19:10 as opposed to the exclusion of foreign dividend income does not demonstrate that the regulation formula operates in a discriminatory manner given the Department's proof that the tax differential from the application of the regulation formula is dependent upon the relative efficiencies of a taxpayer's foreign and domestic operations. Since the tax effect of the application of the Department's regulation is not dependent upon the foreign or domestic source of the income taxed, there is no inherent unequal treatment of or facial discrimination against foreign commerce.[9]

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[9] Although Intel only raised a facial discrimination claim, given the fact that the tax consequences of the application of the Department's regulation turn on circumstances other than the domestic or foreign nature of the income itself, it would also appear that Intel could not prove discrimination against foreign commerce in effect.

Based upon the fact that Intel's claim for refund of taxes is based upon the total exclusion of its foreign dividend income and deemed dividends, its protest is partially denied. Intel's protest is partially granted as well, since Intel is entitled to a refund of the difference between the amount of taxes paid and the amount which would be owing after the application of Regulation UDI 19:10 to Intel for the relevant tax years.

CHILD CARE CREDIT

The remaining issue to be determined is whether Intel is entitled to claim the child care credit provided for at Section 7-2A-14(A) NMSA 1978 (1993 Repl. Pamp.). It provides as follows:

> A taxpayer that pays for child care services in New Mexico for dependent children of an employee of the taxpayer during the employee's hours of employment may claim a credit against the corporate income tax imposed pursuant to the Corporate Income and Franchise Tax Act [this article] in an amount equal to thirty percent of the total expenses for child care services ***incurred and paid*** by the taxpayer in the taxable year. (emphasis added).

Subsection D of Section 7-2A-14 limits the amount of the credit to $30,000.

For the 1991 tax year Intel claimed the full credit. The expenses claimed by Intel were in two categories. The first category were Intel's expenses for providing child-care referral services to its employees. The Department has allowed those expenses and they are not at issue

herein. The second category were expenses claimed under a "cafeteria" plan under IRC §§ 125 and 129 for dependent care, hereinafter referred to as a dependent care assistance plan (DCAP Plan). Under this plan employees estimated their child care expenses for the year and designated that amount as a salary reduction from the employees' salaries. The amounts which can be deducted are limited by the Internal Revenue Code. The deducted amounts are not counted as part of the employees' gross income for federal (or New Mexico) purposes. After an employee incurs allowable dependent care expenses, the employee submits documentation of those expenses to the DCAP Plan and obtains reimbursement of those expenses. Any amounts which an employee designates to the plan which are not withdrawn during the tax year are forfeited by the employee.

The Department contends that Intel is not eligible to claim these expenses for purposes of the corporate child care credit because, since the expenses are really the employees' expenses which are paid for by the employees through a salary reduction plan, the expenses are not "incurred and paid" by Intel as required by the language of Section 7-2A-14(A). Actually, the Department does not dispute that the expenses were paid by Intel, but they dispute that Intel "incurred" the expenses because the economic burden of the expense actually fell on the employee through a salary reduction. Additionally, the Department does not dispute that Intel is allowed to deduct these child care expenses for purposes of federal and New Mexico income tax purposes, but it argues that since it is allowed this deduction, the Legislature would not have intended that it receive both a deduction from

income as well as a credit against tax due for the same expenditure.

This is a matter of first impression in New Mexico. Although, admittedly, the Department's arguments have an appeal from a tax policy perspective, I cannot find support for them in the actual language of the statute itself. Intel has cited to federal authority, ***Apple Computer, Inc. v. Commissioner***, 98 T.C. 232 (1992) in support of its argument that "incurred" and "paid", are terms of art when used in federal tax statutes which refer to the taxpayer's method of accounting, with "incurred" referring to accrual method taxpayers, and "paid" referring to cash method reporting taxpayers. It is noteworthy, that IRC § 129, the code section creating the dependent care assistance program uses the phrase "incurred or paid". The Department does not dispute that Intel is entitled to the federal deduction for its DCAP program expenses, including the amounts it reimburses employees for DCAP expenses. As an accrual basis taxpayer, then, it has "incurred" such expenses. Since New Mexico uses federal taxable income as a starting point in calculating New Mexico base income for corporate income tax purposes, it makes sense to interpret the phrase "incurred" the same as the federal definition. New Mexico recognizes that Intel has incurred the expense for purposes of calculating New Mexico base income under the corporate income tax statutes. Accordingly, it should also recognize that Intel has incurred the expense for purposes of a credit under the same act.

For the foregoing reasons, Intel's protest to Assessment No. 1775546 is granted.

CONCLUSIONS OF LAW

1. Pursuant to Section 7-1-24 NMSA 1978, Intel filed timely, written protests to the Department's denials of its refund claims for 1988, 1989, 1990 and 1991; and Intel filed a timely, written protest to Assessment No. 1775546. Accordingly, jurisdiction lies over both the parties and the subject matter of this protest.

2. Intel's dividend and Subpart F and PFIC income from its foreign subsidiaries is income from foreign commerce.

3. There is no reason to treat Intel's foreign source Subpart F and PFIC income any differently than its actual foreign source dividend income for purposes of Commerce Clause analysis.

4. As applied to Intel, which has elected to report New Mexico corporate income taxes on a separate corporate entity basis and which has received dividend income from both foreign and domestic subsidiaries, New Mexico's corporate income tax scheme facially discriminates against Intel's foreign source dividend income in contravention of the Foreign Commerce Clause of the United States Constitution.

5. Pursuant to Section 7-1-60 NMSA 1978, Intel is entitled to rely upon the separate corporate entity filing method it has chosen pursuant to Regulation CIT 9:2 and the Department is estopped from applying or requiring Intell [sic] to file by any other reporting method for the tax years in issue.

6. Although granting the refunds requested by Intel is one way to remedy the unconstitutional discrimination

which Conoco suffers under New Mexico's corporate income tax scheme, the Department may fashion any remedy it chooses, so long as the remedy has the effect of eliminating the discrimination complained of.

7. For purposes of analyzing whether discrimination exists under the Commerce Clause, there is no such thing as a constitutionally defective tax base. The entire operation of the state's taxing scheme must be analyzed to determine if it operates in a discriminatory manner.

8. Whether a tax is fairly apportioned and whether a tax discriminates against foreign commerce are two separate concepts which must be analyzed separately under the Commerce Clause. Nonetheless, the operation of an apportionment scheme may have the effect of altering a tax scheme in such a way as to remedy an otherwise discriminatory regulatory scheme.

9. As compared with the total exclusion of a separate corporate entity filer's foreign dividend income, the application of Regulation UDI 19:10 may result in equal, higher, or lower New Mexico corporation income taxes. Because the tax result turns on the relative efficiencies of the taxpayer's domestic and foreign operations, and not upon the foreign or domestic source of the taxpayer's income, the application of Regulation UDI 19:10 remedies the discrimination caused by the inclusion of the taxpayer's foreign dividend income while its domestic dividend income is excluded from consideration.

10. Intel "incurred and paid" eligible child care expenses when it reimbursed its employees for dependent care expenses under Intel's DCAP program and is

therefore eligible for the credit which it claimed for the 1991 tax year pursuant to Section 7-2A-14 NMSA 1978.

For the foregoing reasons, the Taxpayer's protest is granted in part and denied in part. It is hereby ordered that the Taxpayer's refund claims for 1988, 1989, 1990 and 1991 are denied to the extent that they exceed the amounts to which it would be entitled after the application of Regulation UDI 19:10, but are granted to the extent of the amounts allowable pursuant to that same regulation. The Department is hereby ordered to pay that portion of Intel's refund claim which has been granted. Additionally, Intel's protest to Assessment No. 1775546 is granted in full and the Department is hereby ordered to abate the assessment in full.

Done, this 2nd day of September, 1994.

/s/ Gerald B. Richardson
Gerald B. Richardson
Special Assistant
Attorney General
Taxation and Revenue
Department
PO Box 630
Santa Fe, NM 87509-0630
(505) 827-0732

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing Decision and Order were served upon the parties by mailing a copy to Curtis W. Schwartz, Esq., c/o Modrall Sperling, Roehl, Harris & Sisk, P.A., PO Box 9318, Santa Fe, NM 87504-9318 and Paul H. Frankel, Esq., c/o Morrison & Foerster, 1290 Avenue of the Americas, New York, NY

10104 and by hand-delivering a copy to Bruce J. Fort, Esq., all on this 2nd day of September, 1994.

/s/ Gerald B. Richardson
Gerald B. Richardson

APPENDIX F

IN THE SUPREME COURT OF THE STATE OF NEW MEXICO

Nos. 22,995/23,045

CONOCO, INC. and INTEL CORPORATION,

Plaintiffs-Petitioners,

vs.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,

Defendant-Respondent.

ORDER

(Filed Jan. 23, 1997)

WHEREAS, Conoco and Intel filed their motion for clarification and the Department filed its motion for reconsideration; and,

WHEREAS, except for Justice Minzner who recused herself by reason of an apparent conflict, the full Court has studied and in conference considered the motions of the parties;

NOW, THEREFORE, the opinion filed herein on November 26, 1996, is amended in part, inter alia, at paragraph 1 to recast the determinitive [sic] issue, in paragraph 6 to specify that the income *of* subsidiary corporations is not reported under the separate-corporate-entity method, in paragraph 14 to delete the hearing officer's reference to a "cap" if dividends exceed profits, in paragraphs 17 and 22 (now 21) to delete reference to

any relative-efficiency rationale, in paragraph 25 to specifically address the denial of a remand to the administrative hearing officer for a determination of any further remedy, and paragraph 26 for further clarification as requested by Taxpayers. The mandate shall issue.

APPENDIX G

IN THE SUPREME COURT OF THE STATE OF NEW MEXICO

January 15, 1997

NO. 22,995

CONOCO, INC.,

Plaintiff-Petitioner,

vs.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,
Defendant-Respondent.

consolidated with:

NO. 23,045

INTEL CORPORATION,

Plaintiff-Petitioner,

vs.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,

Defendant-Respondent.

ORDER

WHEREAS, this matter came on for consideration upon the Court's own motion to extend the time in Which to consider the motion for rehearing, and the Court being sufficiently advised;

NOW, THEREFORE, IT IS ORDERED that the motion hereby is GRANTED and the time in which to consider the motion for rehearing shall be extended to **February 12, 1997.**

APPENDIX H

IN THE SUPREME COURT OF THE STATE OF NEW MEXICO

MANDATE NOS. 22,995/23,045

To the New Mexico Taxation and Revenue Department, GREETINGS:

WHEREAS, in causes on your docket wherein Conoco, Inc. and Intel Corporation are corporate taxpayers;

WHEREAS, the cause and judgment were afterwards brought by taxpayers into the New Mexico Court of Appeals whereupon separate opinions were entered on May 1, 1995, and June 30, 1995, respectively, holding that applicable New Mexico corporate income tax scheme does not treat dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries and therefore not violative of the Foreign Commerce Clause of the U.S. Constitution;

WHEREAS, the cause and judgment were afterwards brought by the taxpayers into this Court by petitions for writ of certiorari, which petitions were granted on July 14, 1995, and August 8, 1995, respectively, whereupon an opinion was entered on November 26, 1996, reversing the judgment of the New Mexico Court of Appeals and finding that the applicable New Mexico corporate income tax scheme is unconstitutional.

NOW, THEREFORE, this cause is remanded to you to allow the refunds sought by the taxpayers and abate the assessment levied by the department and for other proceedings, if any, consistent and in conformity with the opinion of this Court.

WITNESS, The Hon. Gene E. Franchini, Chief Justice of the Supreme Court of the State of New Mexico, and the seal of said Court this 23rd day of January , 1997.

(SEAL)

/s/ Kathleen Jo Gibson
Kathleen Jo Gibson, Chief Clerk
of the Supreme Court of
the State of New Mexico

ATTEST A TRUE COPY

/s/ Kathleen Jo Gibson

APPENDIX I

7-2A-1. Short title.

Chapter 7, Article 2A NMSA 1978 may be cited as the "Corporate Income and Franchise Tax Act".

7-2A-2. Definitions.

For the purpose of the Corporate Income and Franchise Tax Act [Chapter 7, Article 2A NMSA 1978] and unless the context requires otherwise:

* * *

C. "base income" means that part of the taxpayer's income defined as taxable income and upon which the federal income tax is calculated in the Internal Revenue Code for income tax purposes;

* * *

J. "net income" means base income adjusted to exclude:

(1) amounts that have been taxed as income under the Banking and Financial Corporations Tax Act; and

(2) amounts that the state is prohibited from taxing because of the laws or constitution of this state or the United States;

* * *

P. "unitary corporations" means two or more integrated corporations that are owned in the amount of

more than fifty percent and controlled by the same person and for which at least one of the following conditions exists:

(1) there is a unity of operations evidenced by central purchasing, advertising, accounting or other centralized services;

(2) there is a centralized management or executive force and centralized system of operation; or

(3) the operations of the corporations are dependent upon or contribute property or services to one another individually or as a group.

7-2A-8. Income allocation and apportionment.

Net income of any taxpayer having income which is taxable both within and without this state shall be, prior to the application of the tax rate provided in Section 7-2A-5, NMSA 1978 of the Corporate Income and Franchise Tax Act [Chapter 7, Article 2A NMSA 1978], apportioned and allocated as follows:

A. except as otherwise provided in Subsections B, C, D and E of this section, income shall be allocated and apportioned as provided in the Uniform Division of Income for Tax Purposes Act [Chapter 7, Article 4 NMSA 1978];

* * *

7-4-1. Short title.

Chapter 7, Article 4 NMSA 1978 may be cited as the "Uniform Division of Income for Tax Purposes Act".

7-4-2. Definitions.

As used in the Uniform Division of Income for Tax Purposes Act [this article]:

A. "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations;

* * *

7-4-10. Apportionment of business income.

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

7-4-19. Equitable adjustment of standard allocation or apportionment.

If the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act [Chapter 7, Article 4 NMSA 1978] do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

A. separate accounting;

B. the exclusion of any one or more of the factors;

C. the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

D. the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

APPENDIX J

UDI 19:10 – SPECIAL RULES – ADJUSTMENT OF APPORTIONMENT DENOMINATORS FOR FOREIGN-SOURCE DIVIDENDS

A. Any corporation that receives foreign-source dividends during the taxpayer's taxable year and that reports its corporate income tax liability to the state as a separate corporate entity and not as a member of a corporate group filing pursuant to Sections 7-2A-8.3 or 7-2A-8.4 may adjust the denominators of its apportionment factors for foreign source dividends received. The taxpayer may increase the denominator of each of its apportionment factors by an amount equal to the respective denominator of the payor stated in United States dollars times the ratio of foreign-source dividends paid to the taxpayer divided by the book income of the payor. Any taxpayer electing to use the adjustment provided by this regulation may not include the amount of foreign source dividends received in the sales factor denominator.

Example 1: C is a corporation deriving income from operations in New Mexico, F, a subsidiary of C, is incorporated and operates solely in a foreign country and derives no income from New Mexico. F's book income for a year is $800,000 from which it pays C a dividend of $120,000. C reports on a separate corporate entity basis to New Mexico for corporate income tax purposes. C may include ($120,000/$800,000 =) 15% of F's property, sales and payroll in the denominators of C's property, payroll and sales factors.

Example 2: C is a corporation deriving income from operations in New Mexico. F, a subsidiary

of C, is incorporated and operates solely in a foreign country and derives no income from New Mexico. F's book income for years 1 through 4 is $800,000, $650,000, $900,000 and $1,000,000. F pays no dividends in years 1, 2 or 3. F pays C a $2,000,000 dividend in year 4. C reports on a separate corporate entity basis to New Mexico for corporate income tax purposes all four years. Because F paid no dividend to C in years 1, 2 and 3, C may not include any amount of F's property, payroll or sales in C's property, payroll or sales factors for years 1, 2 or 3. C may include ($2,000,000/$1,000,000=) 200% of F's property, payroll and sales factors for year 4 in C's year 4 factor denominators.

B. For the purposes of this regulation, the term:

1) "foreign-source dividend" means a dividend that is:

(a) reported on the taxpayer's federal Form 1120, Schedule C, line 13 and is not totally or partially deductible as a special federal deduction on line 29a of the taxpayer's federal Form 1120 as those forms, schedules and lines were in effect for the federal 1992 taxable year or the equivalent form, schedule or line for other federal taxable years; and

(b) included on the taxpayer's return to New Mexico as apportionable income; and

2) "book income" means the amount described on federal form 5471, Schedule C, line 21 as the form, schedule and line were in effect for taxable years ending in 1992 or the equivalent form, schedule or line for other taxable years.

C. This regulation is retroactively effective for taxable years beginning on or after January 1, 1988.

D. The following federal forms are appended to this regulation:

1) The 1992 federal Form 1120; and

2) The 1992 federal Form 5471.

Adopted 3/17/94 (Rule UDI-93, Amendment No. 1), retroactively effective for taxable years beginning on or after 1/1/88.

APPENDIX K

IN THE SUPREME COURT OF
THE STATE OF NEW MEXICO

Opinion Number ___
Filing Date ___
Docket Nos. 22,995/23,045

CONOCO, INC., and INTEL CORPORATION,

Plaintiffs-Petitioners,

vs.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,

Defendant-Respondent.

ORIGINAL PROCEEDING ON CERTIORARI

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Hon. Mack Easley
Albuquerque, NM — for Amicus Curiae Committee on State Taxation

Taichert, Wiggins, Virtue & Najjar
Daniel A. Najjar
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for Amicus Curiae
Intel Corporation

OPINION

(Filed Nov. 26, 1996)

RANSOM, Justice.

1. We here review the constitutionality of New Mexico's tax on dividends received by a parent corporation from its foreign subsidiaries notwithstanding that dividends received from domestic subsidiaries were excluded from the parent's tax base. Conoco, Inc., and Intel Corporation had sought the refund of such taxes paid by them as separate corporate entities for 1988, 1989, and 1990. Hearing officers for the New Mexico Taxation and Revenue Department denied the refunds. In the Conoco case the hearing officer also upheld an assessment issued by the Department against Conoco for underpaid taxes for 1991. Conoco and Intel each appealed to the Court of Appeals.

2. The Court of Appeals decided Conoco's case first and held that the applicable New Mexico corporate income tax scheme does not treat dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries and therefore is not violative of the Foreign Commerce Clause of the United States Constitution, Article I, Section 8, Clause 3. *Conoco, Inc. v. Taxation & Revenue Dep't*, ___ N.M. ___, ___ P.2d ___ (Ct. App. 1995) (No. 15,372). We granted certiorari and allowed Intel to file an amicus curiae brief. The Court of Appeals then held in an unpublished memorandum opinion that

the Intel appeal was governed by its decision in *Conoco*. We granted certiorari for consolidation with *Conoco*. We find that the applicable New Mexico corporate income tax scheme is unconstitutional, and we reverse the Court of Appeals.

3. *The Taxpayers.* Conoco and Intel both conduct business within New Mexico. Conoco's primary business in New Mexico is exploration, production, and distribution of oil and gas products. Conoco is a wholly owned subsidiary of E.I. duPont de Nemours and Company. Intel's primary business in New Mexico is the manufacture of microcomputer companies. Both corporations conduct business worldwide through numerous domestic and foreign subsidiaries. None of the foreign subsidiaries conduct business in New Mexico. During all relevant years, both Conoco and Intel fled New Mexico corporate income tax returns as "separate corporate entities."

4. *New Mexico tax scheme.* In *Conoco,* reported immediately following our instant opinion, Chief Judge Apodaca of the Court of Appeals provides a discussion of the New Mexico corporate income tax scheme. Aside from the Foreign Commerce Clause, on which this case turns, there are other constraints on a state's power to tax multijurisdictional business entities. The Due Process Clause of the Fourteenth Amendment requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. v. Maryland,* 347 U.S. 340, 344-45 (1954). A state tax on business activities occurring outside the state satisfies the due process clause only if "the taxing power exerted by the state bears fiscal relation to protection, opportunities

and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940), *quoted in ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982). To ensure that the state does not tax value attributable to business conducted outside of the state, a state must use some type of apportionment formula to determine what income was earned within the state and also what portion of income earned extraterritorially is attributable to the corporation's in-state business activity. *See Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439-40 (1980).

5. To a corporate taxpayer's base income New Mexico applies an apportionment formula pursuant to the Uniform Division of Income for Tax Purposes Act, NMSA 1978, §§ 7-4-1 to -21 (Repl. Pamp. 1995) ("UDITPA"). UDITPA uses a three-part formula to apportion income between that which is subject to New Mexico taxation and that which is not. This apportionment method divides a corporation's assets into a property factor, a payroll factor, and a sales factor. *See* NMSA 1978, § 7-4-10 (Repl. Pamp. 1995). To determine each of the factors, the in-state value of an asset is divided by the total value of the asset (including in-state and out-of-state value). The resulting three fractions are then added together and divided by three to create a multiplier that is applied to the corporation's total income. This calculation yields the apportioned income that is subject to taxation in New Mexico. *Id.* As discussed later under the "Detroit formula" heading, the Department has attempted to similarly apportion foreign-subsidiary dividends to satisfy Foreign Commerce Clause considerations. Whether the

Detroit formula satisfies the Foreign Commerce Clause is the determinative issue of this case.

6. -*Separate corporate entity.* During the years relevant to this case, corporations filing tax returns in New Mexico could choose from four different income reporting methods: separate accounting, separate corporate entity, combination of unitary corporations, or federal consolidated group. *See* Regulations Pertaining to the Corporate Income and Franchise Tax Act, N.M. Tax and Rev. Dep't, Rule CIT 9:2(B) (1992) (Reporting Methods). Both Conoco and Intel elected to file according to the separate corporate entity method, in which the corporation reports its entire income, to which an apportionment formula is then applied.

7. Like at least thirty-nine other states, New Mexico uses a corporate taxpayer's federal taxable income, with the deductions allowed by 26 U.S.C. § 243 (1988), as the "base income" for state income tax purposes. *See* NMSA 1978, § 7-2A-2(C) (Repl. Pamp. 1995). Since the entire earnings of domestic subsidiaries are already subject to federal taxation, section 243 of the Internal Revenue Code avoids multiple taxation by allowing corporations to deduct dividends received from domestic subsidiaries. Therefore, dividends from domestic subsidiaries are not included in federal taxable income. To eliminate multiple taxation of earnings of foreign subsidiaries, the federal government allows a subsequent credit to corporations for taxes paid to foreign governments. 26 U.S.C. § 901 (1988). However, dividends from foreign subsidiaries are initially included in federal taxable income. By using federal taxable income as a base, New Mexico excludes domestic but includes foreign dividend income in the

state base income. Conoco and Intel contend that including foreign subsidiary dividends in the calculation of New Mexico taxable income while excluding domestic subsidiary dividends facially discriminates against foreign commerce in violation of the Foreign Commerce Clause. *See Kraft Gen. Foods v. Iowa Dep't of Revenue*, 505 U.S. 71 (1992).

8. In *Kraft*, the U.S. Supreme Court held that Iowa's corporate income taxation scheme facially discriminated against foreign commerce in violation of the Foreign Commerce Clause. Iowa, like New Mexico, used federal taxable income as the base income for state income tax purposes, but unlike New Mexico it did not apply the Detroit formula. Iowa made several arguments in support of the proposition that its differential treatment did not constitute prohibited discrimination, but each of these arguments was rejected by the Court. *Id.* at 74-82. The Court held that the fact corporations could change their domicile or corporate structure to avoid the disparate effects of the tax did not make the tax constitutional. *Id.* at 74-78. The Court also rejected Iowa's argument that because the tax did not favor local commerce it did not violate the Foreign Commerce Clause. "As the absence of local benefit does not eliminate the international implications of the discrimination, it cannot exempt such discrimination from Commerce Clause prohibitions." *Id.* at 79.

9. Iowa's claim that its tax scheme was intended to promote administrative convenience rather than economic protectionism was also insufficient to make it valid. *Id.* at 81-82. While adopting the federal definition of "taxable income" may bring significant benefits in

terms of administrative convenience to both Iowa taxpayers and tax collectors, the Court found these benefits were not the sort of "compelling justification" capable of saving a statute that facially discriminates against foreign commerce. *Id.* (citing *Philadelphia v. New Jersey*, 437 U.S. 617, 626-28 (1978); *Maine v. Taylor*, 477 U.S. 131, 148, n.19 (1986)). The Court observed that "Iowa could enjoy substantially the same administrative benefits by utilizing the federal definition of taxable income, while making adjustments that avoid the discriminatory treatment of foreign subsidiary dividends." *Id.* at 81. In the wake of *Kraft*, other states' corporate tax schemes have come under Foreign Commerce Clause scrutiny, with varied results.

10. In *Dart Industries, Inc. v. Clark*, 657 A.2d 1062, 1066 (R.I. 1995), the Supreme Court of Rhode Island held that Rhode Island's corporate taxation scheme violated the Foreign Commerce Clause because of its similarity to the tax scheme invalidated in *Kraft*. Like Iowa and New Mexico, Rhode Island included dividend income from foreign subsidiaries in the tax base of the parent corporation, but excluded dividend income from domestic subsidiaries. In calculating its net income for the tax years in question, Dart Industries, like Conoco and Intel in this case, excluded foreign dividend income. After reviewing the Rhode Island tax scheme, the *Dart* court held that *Kraft* was controlling.

> In a manner similar to the Iowa statute at issue in *Kraft*, Rhode Island's [tax scheme] treats dividends paid by a foreign corporation less favorably than those paid by domestic corporations. Although the Rhode Island and Iowa statutes

> differ in minor respects, the fatal flaw in the Iowa statute is present in [the Rhode Island statute]: a preference for domestic commerce over foreign commerce. As such, we are compelled to hold that [the Rhode Island scheme] "facially discriminates against foreign commerce and therefore violates the Foreign Commerce Clause."

Id. at 1066 (quoting *Kraft*) (citations omitted).

11. In *In re Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993), the Supreme Court of Kansas upheld a state corporate income tax scheme utilizing the domestic combination method of apportionment. Under this method, a member of a unitary corporation, whose "various parts are interdependent and of mutual benefit so as to form one integral business," is taxed on the apportioned share of the income from all members doing business in the United States, regardless of country of origin, and dividends paid by foreign subsidiaries. *Id.* at 1178. The court noted the analogies between this tax scheme and Iowa's, but determined that the inclusion of income from domestic subsidiaries into the parent's tax base distinguished Kansas' scheme from Iowa's.

> [In *Kraft*, t]he Supreme Court compared a parent corporation with a domestic subsidiary which does not do business in Iowa to a parent corporation with a foreign subsidiary which does not do business in Iowa. In this comparison, Iowa discriminated against the parent corporation with the foreign subsidiary because Iowa allowed a deduction for the dividends received by the parent with the domestic subsidiary, but not for the dividends received by the parent with the foreign subsidiary. . . . [However,] *Kraft*

> "does not address the taxation of foreign dividends by domestic combination states." Clearly, *Kraft* does not hold that the taxation of foreign dividends by a combination method is facially unconstitutional. . . . Allowing a deduction for the domestic dividend avoids double taxation. It is the use of the domestic combination method which distinguishes the Kansas and Iowa tax schemes.

Id. at 1186 (quoting argument of Department of Revenue).

12. Most recently, the Maine Supreme Judicial Court upheld the constitutionality of Maine's corporate taxation scheme, which utilizes the "water's edge combined reporting method." *E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, 84-85 (Me. 1996). Under this method of apportionment, income earned by domestic subsidiaries is included in the amount apportioned to Maine. Thus Maine directly taxes an apportioned part of the domestic subsidiary's income. "Maine's use of the water's edge combined reporting method limits the State to the nation's boundaries in calculating corporate income, and hence no income of foreign subsidiaries is apportioned to Maine." *Id.* at 87. The Assessor adds foreign subsidiary dividends paid to the domestic parent "because these dividends represent value earned by the parent that is not otherwise captured." *Id.* at 87-88. Echoing the reasoning of the *Morton Thiokol* court, the *Du Pont* court noted that "[i]n *Kraft*, the Supreme Court considered the constitutionality only of Iowa's single entity reporting system." *Id.* at 87. The court held that *Kraft* did not apply to the Maine tax scheme because "[f]ar from discriminating against foreign commerce, Maine's water's edge combined reporting method provides a type

of 'taxing symmetry' that is not present under the single entity system." *Id.* at 88.

> Although the dividends paid to parent corporations with domestic subsidiaries are not taxed, the apportioned income of the domestic subsidiaries is subject to tax. Because the income of the unitary domestic affiliates is included, apportioned, and ultimately directly taxed by Maine as part of the parent company's income, the inclusion of dividends paid by foreign subsidiaries does not constitute the kind of facial discrimination against foreign commerce that caused the Supreme Court to invalidate Iowa's tax scheme in *Kraft*. Thus, Maine's use of a water's edge combined reporting method distinguishes Maine's taxing scheme from the scheme invalidated by the United States Supreme Court in *Kraft*.

Id. Like the Supreme Court of Kansas in *Thiokol*, the *Du Pont* Court was able to distinguish the challenged tax scheme from Iowa's tax scheme because Maine included a portion of the domestic subsidiaries' income in the tax base of the parent. However, this "taxing symmetry" is not present in the New Mexico tax scheme.

13. The tax schemes of Kansas and Maine have been upheld as distinguishable from the Iowa and Rhode Island schemes invalidated in *Kraft* and *Dart*. New Mexico's corporate tax scheme is virtually identical to Iowa's and Rhode Island's, except for its use of the Detroit formula. Therefore, the New Mexico tax scheme violates the Foreign Commerce Clause unless saved by the Detroit formula.

14. -*The Detroit formula.* The Detroit formula, named after an agreement between the Ford Motor Company and the city of Detroit, operates to reduce the New Mexico taxable income base by adding into the denominators of the parent corporation's property, payroll, and sales a portion of the property, payroll, and sales of dividend-producing foreign subsidiaries. *See* Regulation UDI 19:10 (issued March 17, 1994, effective retroactively to January 1, 1988). This portion is determined by dividing the net dividends the parent corporation receives from foreign subsidiaries by these subsidiaries' total net profit. *Id.* The Department's hearing officers noted that under the Detroit formula "[t]he percentage of the foreign subsidiary's property, payroll and sales to be included is the ratio that the net dividends received from such subsidiary bears to the subsidiary's net profits, but not to exceed 100%." This addition into the divisors ultimately lowers the multiplier used against a taxpayer's total income, which lowers its New Mexico tax base.

15. The Department argues that the application of the formula remedies the differential treatment of domestic and foreign commerce in the New Mexico tax scheme by reducing the amount of taxes paid. The formula, however, does not eliminate dividends paid by foreign subsidiaries from the tax base in every case. In particular, it did not do so in these two cases. The hearing officers below found that the Taxpayers were paying more money under the Detroit formula than if the dividends from foreign subsidiaries were excluded. Both hearing officers also stated that it was doubtful that every dollar paid by foreign subsidiaries was excluded from the tax base through the application of the Detroit formula. *Kraft*

clearly requires that foreign and domestic commerce be treated equally, and the New Mexico tax scheme fails to do this, even with the Detroit formula.

16. As the Supreme Judicial Court of Massachusetts noted with respect to discriminatory taxes in interstate commerce, "the extent of the economic burden imposed by the excise 'is of no relevance to the determination whether a State has discriminated against interstate commerce.' " *Perini Corp. v. Commissioner of Revenue*, 647 N.E.2d 52, 57 n.7 (Mass. 1995) (quoting *Wyoming v. Oklahoma*, 502 U.S. 437, 455 (1992)). "When a tax, on its face, is designed to have discriminatory economic effects, the Court 'need not know how unequal the Tax is before concluding that it unconstitutionally discriminates.' " *Id.* (quoting *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 406-07 (1984) (quoting *Maryland v. Louisiana*, 451 U.S. 725, 760 (1981))).

17. The Detroit formula does not remove all of the dividends paid by foreign subsidiaries from the tax bases of these Taxpayers. It fails to neutralize the discriminatory effect of the separate corporate entity method for taxpayers with foreign dividend income because the extent to which it eliminates this discriminatory effect depends on the relative efficiencies of a corporations's foreign and domestic subsidiaries. As Judge Donnelly stated in his dissent below, "if the economic efficiency of Taxpayer's foreign operations exceeds that of its domestic operations, Taxpayer's New Mexico income tax is increased." *Conoco*, ___ N.M. at ___, n.4, ___ P.2d at ___, n.4 (Donnelly J., dissenting). Judge Donnelly aptly concludes:

> [The regulation applying the Detroit formula] results in a diminution of the apportionment formula and presumably lessens the taxpayer's tax liability. However, the Detroit formula does not remove the foreign subsidiary dividend income from the Taxpayer's tax base. Thus, Taxpayer's total foreign subsidiary dividend income remains subject to taxation under the Department's regulation. Consequently, Regulation UDI 19:10, which employs the Detroit formula, falls well short of the "strict rule of equality" required in interstate commerce clause cases.

Id. at ___, ___ P.2d at ___. Accordingly, we hold that taxing of dividends from foreign subsidiaries under the separate corporate entity method is unconstitutional, even with the Detroit formula.

18. *Taxpayers' burden of proof.* The Department relies on the Taxpayers' failure to meet their burden of proof under *United States v. Salerno*, 481 U.S. 739 (1987), in which the Court required a defendant challenging pretrial detention based on future dangerousness under the Bail Reform Act to show that "no set of circumstances exists under which the Act would be valid. The fact that the Bail Reform Act might operate unconstitutionally under some conceivable set of circumstances is insufficient to render it wholly invalid. . . . " *Id.* at 745. Dissenting in *Kraft*, Chief Justice Rehnquist unsuccessfully argued for the application of the no-set-of-circumstances test, quoting this language from *Salerno*. *Kraft*, 505 U.S. at 82-83 (Rehnquist, C.J., dissenting). The Department interprets this language to mean that the Taxpayers have the burden of proving that New Mexico's corporate income tax scheme discriminates

against every conceivable taxpayer in order to prove that the tax is facially discriminatory.

19. This language in *Salerno* and subsequent cases involving due process challenges lend some support to the proposition that *Salerno* articulated the burden of proof for any facial challenge to the constitutionality of a statute. *See Reno v. Flores*, 507 U.S. 292, 300 (1993) (applying *Salerno* to due process challenge to Immigration and Naturalization Service regulations regarding release of alien juveniles from detention); *Rust v. Sullivan*, 500 U.S. 173, 183 (1991) (applying *Salerno* to uphold Health and Human Services regulations limiting ability of Title X fund recipients to engage in abortion-related activities); *Caplin & Drysdale v. United States*, 491 U.S. 617, 634 (1989) (requiring challenger of forfeiture action on due process grounds to show forfeiture rule was "inherently unconstitutional"); *Dean v. McWherter*, 70 F.3d 43, 45 (6th Cir. 1995) (applying no-set-of-circumstances test to a Fourteenth Amendment due process challenge in upholding Tennessee law labelling sex offenders "a species of mentally ill persons in the eyes of the general assembly"); *Jordan by Jordan v. Jackson*, 15 F.3d 333, 343-44 (4th Cir. 1994) (relying on no-set-of-circumstances test against due process facial challenge to uphold Virginia statute delaying judicial review of emergency child custody decisions).

20. However, the test has also been questioned. *See Janklow v. Planned Parenthood*, 116 S. Ct. 1582 (1996) (memorandum of Stevens, J., respecting denial of certiorari). Justice Stevens drew a distinction between the longstanding principle that a facial challenge to a statute must do more than show it might operate unconstitutionally in

some conceivable set of circumstances and *Salerno*'s "rhetorical flourish" that went well beyond that principle in requiring a litigant to establish that there is no set of circumstances under which the statute would be valid. *Id.* at 1583.

> That statement was unsupported by citation or precedent. It was also unnecessary to the holding in the case, for the Court effectively held that the statute at issue would be constitutional as applied in a large fraction of cases. . . . [T]he dicta in *Salerno* "does not accurately characterize the standard for deciding facial challenges," and "neither accurately reflects the Court's practice with respect to facial challenges, nor is it consistent with a wide array of legal principles." For these reasons, *Salerno*'s rigid and unwise dictum has been properly ignored in subsequent cases even outside the abortion context.

Id. (citations omitted) (quoting Michael C. Dorf, *Facial Challenges to State and Federal Statutes*, 46 Stan. L. Rev. 235, 236, 238 (1994)). *Contra Janklow*, 116 S. Ct. at 1582 (Scalia, J., joined by Rehnquist, C.J., Thomas, J., dissenting from denial of certiorari) (strongly dissenting from Justice Stevens' memorandum). In *Planned Parenthood, Sioux Falls Clinic v. Miller*, 63 F.3d 1452 (8th Cir. 1995), the Eighth Circuit did not follow *Salerno* because it believed "the Court effectively overruled *Salerno* for facial challenges to abortion statutes." *Id.* at 1458 (same case as *Janklow*). In *Casey v. Planned Parenthood*, 14 F.3d 484, 863 (3rd Cir. 1994), the Third Circuit questioned *Salerno* and noted that in *Planned Parenthood of Southeastern Pa. v. Casey*, 505 U.S.

833 (1992), the Court did not follow *Salerno* and apparently replaced the no-set-of-circumstances standard with the less stringent large fraction test.

21. If the application of the no-set-of-circumstances test to due process challenges is questionable, its application to this Foreign Commerce Clause challenge is even more questionable. In *Kraft* the majority declined to accept Chief Justice Rehnquist's invitation to apply *Salerno* and uphold Iowa's tax scheme. *Kraft*, 505 U.S. at 82-87. The rationale behind the Court's decision in *Kraft* is instructive. It considered and rejected an argument advanced by Iowa and the United States that corporations could avoid the differential treatment of domestic and foreign commerce if they were organized differently. *Id.* at 78. If the no-set-of-circumstances test had applied, this argument would have been persuasive since it would have shown that under some circumstances the tax could operate constitutionally. Under *Salerno*, this argument would defeat the facial challenge. The *Kraft* Court's rejection of this argument indicates that the no-set-of-circumstances test did not apply. We note also that *Salerno* was not applied in any of the post-*Kraft* decisions discussed above. *See Morton Thiokol*, 864 P.2d at 1184-86; *Du Pont*, 675 A.2d at 86-88; *Dart*, 657 A.2d at 1062-66.

22. While we recognize that Chief Justice Rehnquist and Justices Scalia and Thomas disagree with Justice Stevens' repudiation of *Salerno* in the context of challenges to abortion-related statutes and perhaps other due process challenges, we also note that *Kraft* indicates that the Chief Justice is alone among current members of the Court in regarding the *Salerno* test as applicable to Foreign Commerce Clause challenges to corporate income tax

schemes. *See Kraft*, 505 U.S. at 72 (Stevens, O'Connor, Scalia, Kennedy, Souter, and Thomas, J.J., in the majority; Rehnquist, C.J., in dissent). For this reason, and the reasons articulated above, we do not think the Taxpayers' claims fail merely because the Detroit formula may have the effect of treating dividends from domestic and foreign subsidiaries equally for certain corporations organized in such a way that their domestic and foreign subsidiaries operate with equal efficiency.

23. The meaning of *Kraft* is clear from the decision itself as well as from subsequent state court decisions: a state corporate income tax scheme that treats dividends from foreign subsidiaries less favorably than dividends from domestic subsidiaries facially discriminates against foreign commerce in violation of the Foreign Commerce Clause. *Id.* at 76-82; *Morton Thiokol*, 864 A.3d at 1183, 1185; *DuPont*, 675 A.2d at 86-88; *Dart*, 657 A.2d at 1066. The mere fact that there may be a set of circumstances in which the tax operates constitutionally will not suffice under *Kraft* to uphold the statute against a challenge to its constitutionality on Foreign Commerce Clause grounds.[1]

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[1] The inapplicability of the no-set-of-circumstances test to this challenge to New Mexico's corporate income tax scheme on Foreign Commerce Clause grounds in no way affects New Mexico precedent regarding the rational basis test for equal protection challenges to classifications. *See Marrujo v. New Mexico Highway Transp. Dep't*, 118 N.M. 753, 887 P.2d 747 (1994). In *Marrujo*, we stated that we "will uphold the statute if any state of facts can be discerned that will reasonably sustain the challenged classification." *Id.* at 758, 887 P.2d at 752. *See also Richardson v. Carnegie Library Restaurant, Inc.*, 107 N.M. 688, 693, 763 P.2d 1153, 1158 (1988); *Espanola Housing Authority v. Atencio*, 90 N.M. 787, 788, 568 P.2d 1233, 1234 (1977); *Board of Trustees of*

Therefore, we find that the Taxpayers did not have the burden of proving that the New Mexico tax scheme, which discriminated against them individually, would discriminate against every conceivable taxpayer.

24. *Voluntary election.* The Department argued that Conoco and Intel are not entitled to relief because any discrimination against foreign commerce was a result of their decision to utilize separate entity filing over other options. The Department cites footnote 23 from *Kraft* to show that the Court approved domestic combined reporting and therefore argues that the Taxpayers had the option of choosing a constitutional method of filing. The language that the Department cites reads as follows:

> If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent.

Las Vegas v. Montano, 82 N.M. 340, 343, 481 P.2d 702, 705 (1971); *Garcia v. Albuquerque Pub. Sch. Bd.*, 95 N.M. 391, 393, 622 P.2d 699, 701 (Ct. App. 1981). This line of cases is still valid as an expression of the minimum scrutiny test for equal protection challenges to classifications.

Kraft, at 80, n.23. Even if the Court implicitly approved domestic combined reporting, an interpretation we are not inclined to accept and do not adopt in this opinion, the existence of constitutional options should not preclude taxpayer relief from the unconstitutional aspects of the option exercised by the taxpayer. Courts will not ignore constitutional challenges merely because the claimant could have chosen another option, the constitutionality of which is not questioned. *See Conoco*, ___ N.M. at ___, ___ P.2d at ___ (citing *Campbell v. Wood*, 18 F.3d 662, 680 (9th Cir. 1994) (reviewing the constitutionality of probation conditions even though incarceration was an option to the probationer), *cert. denied*, 114 S. Ct. 2125 (1994)). In Intel's action before the Department's hearing officer, the officer stated that

> Intel has exercised the right given it by the Secretary in Regulation CIT 9:2 to file under the separate corporate entity filing method. Having made a valid election of filing methods, Intel is entitled to have that filing method applied to it in a constitutional manner.

We agree with both the Court of Appeals and the hearing officer and find that the presence of other reporting options is not relevant to the Taxpayers' claim.

25. *Refund of collected taxes.* The Taxpayers assert that the Department must refund any taxes collected pursuant to an unconstitutional tax. It is true that the Department is authorized to make refunds under certain circumstances. *See, e.g., Neff v. State*, 116 N.M. 240, 245, 861 P.2d 281, 286 (Ct. App. 1993). When a tax is found unconstitutional, the Department may "either award full refunds to those burdened by an unlawful tax or issue some other order that

'create[s] in hindsight a nondiscriminatory scheme.' " *Harper v. Virginia Dep't of Revenue*, 509 U.S. 86, 101 (1993) (quoting *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 40 (1990)). *See also Dart*, 657 A.2d at 1067 (requiring under Rhode Island law "a refund when a taxpayer has prepaid a tax and is subsequently successful in challenging the legality of that tax"). The Department apparently attempted to create a nondiscriminatory scheme with the retroactive application of the Detroit formula, but this attempt was unsuccessful. We remand this matter to the district court for a determination, consistent with this opinion, of the proper remedy for these Taxpayers.

26. *Conclusion*. The New Mexico corporate income tax scheme unconstitutionally discriminates against foreign commerce. The separate corporate entity method of corporate taxation violates the Foreign Commerce Clause of the United States Constitution, and the Detroit method is an insufficient remedy. Therefore, the opinion of the Court of Appeals is reversed. The refunds sought by the Taxpayers should be allowed and the penalty assessment levied by the Department should be abated.

27. **IT IS SO ORDERED.**

/s/ Richard E. Ransom
RICHARD E. RANSOM, Justice

WE CONCUR:

/s/ Gene E. Franchini
GENE E. FRANCHINI, Justice

/s/ Dan A. McKinnon III
DAN A. McKINNON, III, Justice

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO,

Petitioner,

v.

CONOCO INC., AND INTEL CORPORATION,

Respondents.

ON PETITION FOR CERTIORARI TO THE
SUPREME COURT OF THE STATE OF NEW MEXICO

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Can New Mexico tax approximately 75% of dividends flowing in foreign commerce (it excludes 25% by including a portion of the factors of the foreign dividend payors in the apportionment formula), when it exempts dividends flowing in domestic commerce entirely, without discriminating against foreign commerce in violation of the Foreign Commerce Clause and this Court's decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992)?

LIST OF PARTIES

The parties to the proceeding below were the same as those mentioned in the present caption.

In the proceeding below, and in the Petition for a Writ of Certiorari, Conoco Inc. is referred to as Conoco, Inc. The corporation's actual name is Conoco Inc. and is so referred to herein.

RULE 29.6 STATEMENT

Respondent Conoco Inc., a Delaware corporation, is a wholly owned subsidiary of Du Pont Energy Company, a Delaware corporation, which is in turn owned 99.8 percent by E.I. du Pont de Nemours and Company, a Delaware corporation. The following are nonwholly owned subsidiaries of Respondent Conoco Inc.:

- Big Sky of Montana Realty, Inc.
- Cit-Con Oil Corporation
- Conch International Methane Limited
- Conoco, A.G.
  - Du Pont Conoco Nordic AB
  - Danube Insurance Ltd.
    - Conoco Arabia Ltd.
    - Conoco Iraq Ltd.
    - Conoco Oriente Ltd.
    - Conoco Peru Ltd.
    - Whitebridge Ltd.
    - Conoco Venezuela Ltd.
    - Conoco Mexico Ltd.
    - Conoco Barbados Ltd.
    - Conoco NW Natuna Exploration and Production Ltd.
    - Conoco Khazar Ltd.
  - OK Coop A.G.
  - Societa Italiana Per L'Oleodotto Transalpino S.p.A.
  - Transalpine Oelleitung in Oesterreich Gesellschaft M.B.H.
  - Gemeinnutzige Wohnungsbaugesellschaft GmbH
  - Conoco Arabia Ltd.
  - Conoco Iraq Ltd.
  - Conoco Khazar Ltd.
  - Conoco Mexico Ltd.
  - Conoco Mineraloel GmbH
    - Deutsche Transalpine Oelleitung GmbH (T.A.L.)
    - Etzel Gas Lager Project
    - Societue du Pipeline Sud-Europeeno S.A.
    - GKG Mineraloelhandel Gmbh & Co. KG
    - Zeller & Cie SARL
    - GKG Mineraloelhandel Handel Verwaltungsgesellschaft mbH
    - Gebinde-Vertungsgesellschaft der Mineraloelwirtschaft mbH
  - Conoco Norway Inc.
    - K/S Statfjord Transport A.S. & CO.

- Statfjord Transport A.S.
- Statoil Metanol A/S
- Tjeldbergodden Luftgassfabrikk DA
- Conoco Oriente Ltd.
- Conoco Peru Ltd.
- Conoco Pipe Line Company
  - Colonial Pipeline Company
  - Dixie Pipeline Company
  - Explorer Pipeline Company
  - Lake Charles Pipe Line Company
  - Pioneer Investments Corp.
    - Pioneer Pipe Line Company
    - Salt Lake Terminal Co.
  - Yellowstone Pipe Line Company
- Conoco Timan-Pechora Ltd.
  - Polar Lights Company
- Conoco Venezuela Ltd.
- Cure Inc.
- Du Pont Energy Company
- Felix Oil Company
- Jupiter Holding, Inc.
  - Jupiter Chemicals, Inc.
  - Jupiter Sulphur, Inc.
- Kayo Oil Company
  - Fas-Gas Retail Services Co. of Texas
  - Sentinel Concessions, Inc.
- Kettleman North Dome Association
- Marine Preservation Association
- Oberrheinische Mineraloelwerke GmbH (OMW)
  - Mineraloelraffinerrie Oberrhein GmbH & Co. KG
- Mineraloelraffinerrie Oberrhein Verwaltungs GmbH
- Petco Enterprises Ltd.
- Petrocokes, Ltd.
- Phoenix Park Gas Processors, Ltd.
- San Jacinto Eastern Corporation
  - Iranian Investment Corporation
  - Iranian Oil Participants Limited
  - Iranian Oil Services (Holding) Limited
- Siam Conoco Land Ltd.
- Siam Conoco Terminal Co. Ltd.
- The Standard Shale Products Company
- Tidelands Royalty Trust

Respondent Intel Corporation is a publicly held corporation with no parent companies and no nonwholly owned subsidiaries.

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Statutes and Regulations:	
Subpart F (I.R.C. §§ 951-964)	3, 5, 20-21
New Mexico Taxation and Revenue Department Regulation UDI 19:10 (1994)	5, 6, 11
72 Pa. § 7401(3)1.(b) (1996)	9
Other Authorities:	
Bill Analysis and Fiscal Impact Report (Bill Number: House Bill 680, Feb. 17, 1993), prepared by New Mexico Taxation and Revenue Department	4, 11
Factor Relief As An Answer To Discrimination Claims Under Kraft General Foods v. Iowa Department of Revenue, prepared by New Mexico Taxation and Revenue Department	13
1992 New Mexico Instructions for Corporate Income and Franchise Taxes, Form CIT-1	3-4n.3
Policy Statement on *Kraft* Decision, [1991-1994 Transfer Binder] Iowa St. Tax Rep. (CCH) ¶ 200-775 (Iowa Dep't of Revenue & Fin. Dec. 14, 1992)	9
Revenue Ruling #92-13, S.C. St. Tax Rep. (CCH) ¶ 300-073 (S.C. Tax Comm'n Dec. 3, 1992)	9
Rhode Island Business Corporation Tax Return Form RI-1120, Schedule B	9

The Respondents, Conoco Inc. and Intel Corporation, respectfully request that this Court deny the petition for a writ of certiorari, seeking review of the Supreme Court of the State of New Mexico's opinion in this case.

STATEMENT OF THE CASE

A. The Facts

1. The *Kraft* Decision

In June, 1992, this Court held in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), that Iowa's corporate income tax scheme facially discriminated against foreign commerce in violation of the Foreign Commerce Clause of the United States Constitution. That was so because Iowa's corporate tax base, just like New Mexico's, included dividends received in foreign commerce, but not dividends received in domestic commerce.

In November, 1996, and again in January, 1997, after denying the Petitioner's Motion for Reconsideration, the New Mexico Supreme Court applied *Kraft* in this case and held that New Mexico's corporate income tax scheme similarly violates the Foreign Commerce Clause.

The source of this disparate treatment of dividend income is the federal definition of taxable income used by most states as their income tax base. Although the majority of states use federal taxable income as their income tax base, only a few states, such as Iowa, New Mexico and Rhode Island, do not by statute eliminate the resulting disparity between the tax treatment of dividends flowing in foreign commerce and dividends flowing in domestic commerce.

The decision in *Kraft* initiated a series of events in New Mexico which culminated in the instant matters. At the heart of these matters is the thinly veiled attempt by the Taxation and Revenue Department of the State of New Mexico (the "Department") to circumvent *Kraft* by using factor representation to tax about 75% of a company's foreign dividends.

2. The Refund Claims and the Department's Response

Conoco Inc. ("Conoco") and Intel Corporation ("Intel") filed their New Mexico tax returns for 1988 to 1991, inclusive, using the separate entity reporting method. In the fall and early winter of 1992, in reliance on *Kraft*, Conoco and Intel (together, "Respondents") filed their respective original tax returns for 1991, and their respective amended returns for 1988 through 1990. The amended returns sought refunds of overpaid taxes and, in accordance with *Kraft*, excluded foreign dividends from the New Mexico tax base in the same manner as all corporations were authorized to exclude domestic dividends from the New Mexico tax base. The 1991 returns similarly excluded foreign dividends from the New Mexico tax base.

In February, 1993, eight months after *Kraft* was decided law, the Department denied Conoco's refund claims for 1988 through 1990 and issued to Conoco a corporate income tax assessment for 1991 which imposed tax on the company's foreign dividend income while not imposing tax on its domestic dividend income. The Department similarly denied Intel's refund claims for 1988 through 1990, and denied the portion of Intel's refund claim for 1991 that was attributable to Intel's exclusion of foreign dividends.[1]

The Department advanced three theories for its prompt actions. First, the Department asserted that *Kraft* should be given "prospective application only." Thus, relying on the doctrine of selective prospectivity, the Department argued that corporate taxpayers were not entitled to any relief with respect to the taxes they had overpaid as a result of New Mexico's unconstitutional scheme for taxing dividend income.[2]

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[1] The Department did not issue an assessment to Intel for 1991, as it did to Conoco, because Intel had overpaid estimated taxes for that year.

[2] In its denial letters to Intel, the Department asserted that its separate entity reporting method with respect to the taxation of domestic and foreign

(Footnote continued)

The Department's second theory for denying relief was premised on its contention that New Mexico's method of dividend taxation in the context of combined and federal consolidated reporting was constitutional. According to the Department, *Kraft* applied only to those corporate taxpayers that used the separate entity reporting method and since, under New Mexico's scheme of corporate income tax reporting, corporations could have elected to use combined or federal consolidated reporting, they presumably had a constitutional reporting method available. Therefore, the Department's argument went, such taxpayers were not harmed by the constitutional infirmities of separate entity reporting -- any harm was purportedly a problem of the taxpayer's own making by not electing to have its income taxed in another manner.

Although limited in applicability, the Department also advanced a third theory for not refunding the unconstitutionally collected taxes. The Department contended that *Kraft* was inapplicable to deemed dividends (such as federal Subpart F income). Under this theory, *Kraft* only applied to actual repatriated foreign dividend income.

3. The Department's Response to *Kraft*

In late 1992, prior to formally denying Respondents' refund claims and asserting an assessment against Conoco, the Department was revising its corporate income tax instructions for 1992. For the 1992 tax year, the Department ordered separate entity taxpayers to exclude foreign dividend income just as domestic dividend income was excluded.[3] *Thus, for 1992,*

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dividends was constitutional and that, in any event, the *Kraft* decision "should be given prospective application only."

[3] The instructions provided that:

> The Iowa statute struck down by the U.S. Supreme Court [in *Kraft*] is substantially similar to the separate entity method of reporting allowed as an option by New Mexico's corporate income tax statutes and may be applicable to New Mexico taxpayers filing under that method of reporting. In order to ensure that New Mexico's corporate income taxes are

(Footnote continued)

the Department adopted the same method to remedy the unconstitutional discrimination that Conoco and Intel were claiming for prior years.

The Department was also keeping the New Mexico Legislature informed of its activities. In late 1992 and early 1993, the Department repeatedly submitted written reports stating that it thought *Kraft* was applicable to New Mexico's scheme for taxing dividend income of separate entity corporate taxpayers. In February, 1993, only days after the denial letters were mailed to Respondents, the Department made public pronouncements and explained to the New Mexico Legislature that "*Kraft v. Iowa* makes it clear that the New Mexico 'separate entity' option is unconstitutional as written." Bill Analysis and Fiscal Impact Report (Bill Number: House Bill 680, Feb. 17, 1993).

In June, 1993, this Court issued *Harper v. Virginia Department of Taxation*, 509 U.S. 86 (1993), and held that the doctrine of selective prospectivity is inapplicable in the context of state tax claims based on violations of federal law, including the U.S. Constitution. *Harper* requires states to afford all taxpayers "meaningful backward-looking" relief to remedy the effects of state tax provisions that violate federal law.

Recognizing that its principal reason for refusing to pay the refunds had been eliminated by *Harper*, in the summer of 1993 the Department informed Respondents that it had abandoned its "prospective only" position and that, instead, it was going to rely upon a new theory (which would allow it to keep about 75% of all known refund claims) -- allow "Detroit Formula" factor representation for foreign dividends paid to separate entity filers.

> administered in a constitutional manner prior to legislative action, the Department will allow an additional deduction for certain foreign dividend[s]. . . .

1992 New Mexico Instructions for Corporate Income and Franchise Taxes, Form CIT-1, at 3.

B. The Proceedings Below

1. The Administrative Hearings

Conoco's and Intel's timely filed administrative protests were heard before the Department's same internal hearing officer at separate formal administrative hearings. The Department first presented its "fairer apportionment eliminates facial discrimination" argument to its internal hearing officer during Conoco's formal administrative hearing. It argued that granting factor representation with respect to foreign dividends, while excluding domestic dividends entirely from the apportionable base, remedied the discrimination found in *Kraft*. At approximately the same time, the Department promulgated a proposed regulation, UDI 19:10, that adopted the Detroit Formula and granted factor representation to separate entity filers.

The Department's internal hearing officer acknowledged that New Mexico's corporate income tax scheme as it pertains to separate entity filers "is indistinguishable in any material or meaningful way from the Iowa corporate income tax scheme found by the United States Supreme Court in *Kraft General Foods, Inc. v. Iowa Department of Revenue* to facially discriminate against foreign commerce in violation of the Commerce Clause of the United States Constitution." (App. D, at App. 90, Finding of Fact No. 86.) The Department's internal hearing officer also concluded as a matter of law that "[a]s applied to Conoco . . . New Mexico's corporate income tax scheme facially discriminates against Conoco's foreign source dividend income in contravention of the Foreign Commerce Clause of the United States Constitution." (App. D, at App. 121, Conclusion of Law No. 4.)

The internal hearing officer also ruled that deemed foreign dividends (*e.g.*, Subpart F income) must be treated identically to actual foreign dividends. In addition, the internal hearing officer held that, even if dividend taxation pursuant to New Mexico's combined or consolidated reporting methods did not suffer from the constitutional infirmities that plagued the State's separate entity method, Conoco had elected to report

using the separate entity method and was entitled to have that method applied to it in a constitutional manner.

The Department's internal hearing officer then ruled that the Detroit Formula provided an adequate remedy to redress the ill effects of the unconstitutional discrimination that Conoco had incurred. This was so despite the fact that (A) use of the Detroit Formula had been shown in this case merely to reduce slightly, but not eliminate, the unconstitutional discrimination that the internal hearing officer found to exist (57% to 93% of Conoco's foreign dividends were subject to New Mexico tax, not 100%), and (B) the Department had *no* examples of a case where discrimination was cured. Notwithstanding these facts, the internal hearing officer affirmed the Department's denial of Conoco's refund claims.

2. The Appellate Hearings

Conoco appealed its case to the New Mexico Court of Appeals. Shortly thereafter, two things of importance occurred. First, on March 17, 1994, the Department finalized its Detroit Formula regulation, UDI 19:10. The regulation was adopted with a retroactive date of January 1, 1988. That date is the beginning of the period for which both Conoco and Intel claimed refunds. According to a study conducted by the Department, the regulation would permit the Department to retain approximately 75% of refund claims resulting from its discriminatory inclusion of foreign dividends.

Second, Intel's case was heard before the Department's same internal hearing officer. The internal hearing officer entered a Decision and Order that is not materially different from the Decision and Order that he had entered in Conoco's case.[4]

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[4] The Decision and Order of the Department's internal hearing officer similarly found that, as applied to Intel, the New Mexico tax scheme facially discriminated against Intel's foreign source dividends in violation of the Foreign Commerce Clause. (App. E, at App. 165, Conclusion of Law No. 4.)

In the Spring of 1995, a three-judge panel of the New Mexico Court of Appeals entered a 2-1 decision in *Conoco*. The majority held that the adjustments to the apportionment formula mandated by the Department's new, retroactive Detroit Formula regulation created "comparability" between apportionment of foreign dividend income and exclusion of domestic dividend income. That was so, the court held, even though the regulation was not adopted until after the case had been tried and was pending on appeal. Judge Thomas Donnelly dissented, concluding that the retroactive Detroit Formula regulation did not correct the problem of Commerce Clause discrimination.

Conoco then filed a petition for certiorari with the New Mexico Supreme Court asking for its review of the Court of Appeals' decision.

The Court of Appeals decision involving Intel was announced shortly after Conoco filed its petition. The three-judge panel in *Intel* ruled that it was bound by the other panel's decision in *Conoco*, but noted that it questioned the decision of the majority and urged review by the New Mexico Supreme Court. Judge Donnelly was also on the *Intel* panel and entered a dissenting opinion similar to the one he had issued in *Conoco*. Intel then filed a petition for certiorari with the New Mexico Supreme Court asking for review of the Court of Appeals' decision in its case.

3. The New Mexico Supreme Court's Decision

In July, 1995, the New Mexico Supreme Court granted certiorari and agreed to hear both cases. On November 26, 1996, a three-judge panel of the court announced its decision that New Mexico's scheme of taxing foreign dividend income in the context of separate entity reporting was an unconstitutional violation of the Commerce Clause, applying *Kraft*. It further held that the Department's Detroit Formula regulation did not save the tax scheme. The court was unequivocal that *Kraft* and other U.S. Supreme Court cases mandate that protected forms of commerce be treated equally and not merely comparably, especially when theoretical comparability

resulted in foreign dividend income being included in the tax base and subject to taxation.

The court noted that the Detroit Formula "does not eliminate dividends paid by foreign subsidiaries from the tax base in every case. In particular, it did not do so in these cases." (App. K, at App. 191, ¶15.) The court continued:

> The Detroit formula does not remove all of the dividends paid by foreign subsidiaries from the tax bases of these Taxpayers. It fails to neutralize the discriminatory effect of the separate corporate entity method for taxpayers with foreign dividend income . . . .

(App. K, at App. 192, ¶17.)

The court also rejected the Department's argument that Conoco and Intel were not entitled to relief on the basis that any discrimination to foreign commerce was a result of their decisions to utilize separate entity filing over the other filing options. "We agree with both the Court of Appeals and the hearing officer and find that the presence of other reporting options is not relevant to the Taxpayers' claim." (App. K, at App. 199, ¶24.)

Shortly after the New Mexico Supreme Court issued its decision, the Department filed a Motion for Reconsideration in which it sought, *inter alia*, a remand to its internal hearing officer. On January 23, 1997, the New Mexico Supreme Court denied the Department's motion, withdrew its previous panel opinion and issued a new, unanimous, 4-0 opinion of the court in Conoco's and Intel's favor.

As part of its request for reconsideration, the Department had asked the court to provide it with another opportunity to avoid paying refunds. In denying the Department's motion, the New Mexico Supreme Court stated:

> Serial litigation of multiple efforts to craft a remedy for specific taxpayers would be an affront to judicial economy and the principle of finality.

(App. A, at App. 20, ¶25.)

REASONS FOR DENYING THE WRIT

A.

THE DECISION OF THE NEW MEXICO SUPREME COURT IS OF LIMITED APPLICABILITY OUTSIDE OF NEW MEXICO

While the instant matter is of great importance to both Conoco and Intel, the decision of the New Mexico Supreme Court has limited applicability outside of New Mexico. Even before this Court issued its decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), many states that used the definition of federal taxable income in computing a corporation's state tax liability made adjustments to avoid the discriminatory treatment of dividends from foreign subsidiaries. *Kraft*, 505 U.S. at 81 and n. 24 (referring to pages in the appendix to the petition for certiorari which list the many states that either exclude all dividends or that tax all dividends equally).

Moreover, of the states that did discriminate against dividends from foreign commerce prior to *Kraft*, several have amended their practice so as to treat dividends from foreign commerce equally with dividends from domestic commerce. For example, Iowa now allows the same deduction for dividends flowing from foreign commerce as it does for dividends flowing from domestic commerce (Policy Statement on *Kraft* Decision, [1991-1994 Transfer Binder] Iowa St. Tax Rep. (CCH) ¶ 200-775 (Iowa Dep't of Revenue & Fin. Dec. 14, 1992); Pennsylvania excludes dividends from both domestic and foreign subsidiaries from its tax base (72 Pa. Stat. § 7401(3)1.(b) (1996)); Rhode Island similarly excludes both forms of dividends from the tax base (*Dart Indus., Inc. v. Clark*, 657 A.2d 1062 (R.I. 1995) and Business Corporation Tax Return Form RI-1120, Schedule B); and South Carolina now excludes both types of dividends from its tax base (Revenue Ruling #92-13, S.C. St. Tax Rep. (CCH) ¶ 300-073 (S.C. Tax Comm'n Dec. 3, 1992)).

Thus, the Department's petition for certiorari should be denied because the decision of the New Mexico Supreme Court is not of a sufficient enough magnitude to warrant review. If the New Mexico Supreme Court's decision affected even several other states, it is likely that at least one of those states would have filed an *amicus curiae* brief in support of the Department. The failure, to date, of even a single state, or organization of states (such as the Multistate Tax Commission or Federation of Tax Administrators), or the Federal Government to file such a brief illustrates the limited applicability that the New Mexico Supreme Court decision has outside of New Mexico.

Moreover, that no other state has, to date, filed an *amicus curiae* brief in support of Petitioner similarly belies Petitioner's assertion that this case "involves an attempt to resolve the 'foreign dividend wars' which have raged across the state tax world for so many years." (Petition at 13.) In reality, this case has nothing to do with the so-called "foreign dividend wars." It is merely an attempt by a single state to continue its discriminatory tax scheme.

Finally, the decisions in *In re Morton Thiokol, Inc.*, 254 Kan. 23, 864 P.2d 1175 (1993), and *E.I. du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996), are irrelevant to the instant matters. Each of those cases involved the applicability of *Krafi* to corporations that filed combined returns. The instant case, however, involves corporations that, like *Krafi*, filed on a separate entity basis. Thus, further review of separate entity filings would not address the issues raised in *Morton Thiokol* or *E.I. du Pont*.

As the foregoing demonstrates, the decision of the New Mexico Supreme Court is of limited applicability outside of New Mexico. The decision is not worthy of this Court's limited resources. The petition for certiorari should therefore be denied.

B.

THE DECISION OF THE NEW MEXICO SUPREME COURT CORRECTLY APPLIES SETTLED PRINCIPLES OF CONSTITUTIONAL LAW AND DOES NOT MERIT REVIEW BY THIS COURT

The tax scheme at issue in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), is identical in all relevant respects to the New Mexico tax scheme. Both tax schemes include in the tax base dividends from foreign commerce, but exclude from the tax base dividends from domestic commerce. In light of this identity, it is indisputable that the New Mexico statute is as constitutionally infirm as the Iowa statute. Both schemes discriminate on their face against foreign commerce and both schemes therefore violate the Foreign Commerce Clause.

The Department does not dispute the foregoing. Indeed, following the decision in *Kraft*, the Department conceded that "*Kraft v. Iowa* makes it clear that the New Mexico 'separate entity' option is unconstitutional as written." Bill Analysis and Fiscal Impact Report (Bill Number: House Bill 680, Feb. 17, 1993).

In a transparent attempt to avoid its constitutional obligation to provide equitable treatment of foreign and domestic dividends, the Department adopted its retroactive Detroit Formula regulation (UDI Reg. 19:10). The Department now relies upon this regulation to defend its disparate treatment of foreign and domestic dividends on theoretical grounds while continuing to tax the former more heavily than the latter. As the New Mexico Supreme Court explicitly found, however, "*Kraft* clearly requires that foreign and domestic commerce be treated equally, and the New Mexico tax scheme fails to do this, even with the Detroit formula." (App. A, at App. 12, ¶15.)

1. The Detroit Formula Fails to Cure the Facial Discrimination in New Mexico's Corporate Income Tax Statute

The Department's Detroit Formula regulation does not create equality between the treatment of dividends from foreign commerce and dividends from domestic commerce. Instead, the regulation is little more than a smoke screen to provide cover for the Department in its continuing attempt to defend its facially discriminatory taxing regime that has been condemned by *Kraft*.

The Detroit Formula regulation does not cure the discrimination embodied in New Mexico's taxing scheme because it fails to provide the same treatment for foreign dividends as for domestic dividends. While dividends from foreign commerce are included in the New Mexico tax base, dividends from domestic commerce are excluded.

The Department's defense of the regulation is predicated on the incorrect premise that a taxing scheme that discriminates on its face against foreign commerce can be remedied by indirect, part-way measures that fail to guarantee equality.

The retroactive "remedy" adopted by the Department is, in practical effect, not a remedy at all. Rather, it is a thinly veiled attempt to retain in the state's coffers 75% of the tax on the foreign dividends that *Kraft* holds the Department may not tax at all.

James O'Neill, Assistant Secretary and Director of Tax Policy for the Department, testified in the Intel case that New Mexico "would retain 75 percent of the amount of refund claim made"[5] if taxpayers' *Kraft*-related refund claims were disposed of by reference to the Department's Detroit Formula regulation, rather than by excluding the foreign dividends

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[5] Transcript, Vol. 1 at 192, lines 20-21 (Mar. 30, 1994).

from the tax base.[6] Consistent with that testimony, the Department stated in a paper it prepared for submission to an interim committee of the New Mexico Legislature entitled *Factor Relief As An Answer To Discrimination Claims Under Kraft General Foods v. Iowa Department of Revenue* that: "As a result of [the 'Detroit Formula' of Factor Adjustment], most taxpayers will receive at least a partial refund, averaging about 25% of what they requested."

Indeed, even the Department's own internal hearing officer was "not convinced that the inclusion of foreign factors under the Detroit formula totally eliminates all foreign based dividend income from the tax base." (App. E, at App. 154.)

It is therefore clear that, despite the Department's assertions to the contrary (Petition at 15-16), the Detroit Formula does not "accomplish[] the same result" as the exclusion of foreign-source dividends from the tax base. If the Detroit Formula truly did accomplish the "same result" (Petition at 16), then the Department would not be retaining "75 percent of the amount of refund claim made."

The Department's alleged remedy fails to satisfy the "strict rule of equality" that governs the adjudication of claims of discrimination under the Commerce Clause. *See, e.g., Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 70 (1963) ("[E]quality for the purposes of competition and the flow of commerce," after all, "is measured in dollars and cents, not legal abstractions."); *see also Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 648 (1994) (quoting *Halliburton*); *cf. Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue*, 460 U.S. 575, 585 (1983) (differential taxation of press forbidden "unless the State asserts a counterbalancing interest of compelling importance that it cannot achieve without differential taxation"). Here, it is clear that Respondents are saddled -- in terms of "dollars and cents" --

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[6] Mr. O'Neill's conclusion was based on an analysis of all *Kraft*-related claims that were pending in the Department.

with an extraordinary tax burden that neither would have borne had their dividends resulted from domestic commerce rather than foreign commerce.

2. The Department Confuses Fair Apportionment with Discrimination

In relying upon its Detroit Formula regulation as an alleged antidote to the discriminatory character of the New Mexico tax base (*i.e.*, inclusion of foreign but not domestic dividends), the Department confuses fair apportionment and discrimination.

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), this Court articulated a four-prong test to determine whether a state tax violates the Commerce Clause. Under this test, a tax will be sustained if the tax (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, *and* (4) is fairly related to the services provided by the state. *Id.* at 279.

The fair apportionment prong articulated in *Complete Auto* was subsequently refined to require that the tax be both internally consistent (*i.e.*, multiple taxation will not result if every state were to impose an identical tax) and externally consistent (*i.e.*, the state is taxing only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed). *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169-70 (1983).

In the area of foreign commerce, this Court has expanded the *Complete Auto* test and required, in addition to the four-prong test, that a tax satisfy two additional requirements:

> first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments."

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 451 (1979). In *Japan Line*, this Court held that a fairly apportioned tax (which also satisfied the other three prongs of *Complete Auto*) violated the Foreign Commerce Clause.

Thus, each of the four prongs articulated in *Complete Auto*, and the additional two prongs articulated in *Japan Line* when foreign commerce is involved, must be satisfied for a state tax to satisfy constitutional muster.

The Department is apparently confused over these separate, independent constitutional requirements. The Department continuously asserts that its Detroit Formula regulation fairly apportions a taxpayer's income. (*E.g.*, Petition at 8-9, 22.) The Department's confusion is illustrated by its comment that the New Mexico Supreme Court "made no attempt to apply the traditional discrimination tests of internal and external consistency put forth by this Court in *Container* and *Armco v. Hardesty*, 467 U.S. 638 (1984)." (Petition at 21, n.8.) As previously discussed, however, internal and external consistency are components of the requirement that a tax be fairly apportioned. They are not part of the separate requirement that a tax not discriminate.[7]

The Department is therefore wrong when it asserts that "[t]he facial discrimination problem identified in *Kraft* and the income distortion problem identified by Justice Stevens in *Mobil* are one and the same." (Petition at 24.) As the foregoing establishes, the two requirements are not "one and the

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[7] In *Armco*, which held that West Virginia's wholesale gross receipts tax discriminated against interstate commerce, this Court stated that its discussion of internal consistency in *Container* pertained to the requirement that a tax be fairly apportioned. *Armco* at 644. The Court further stated that a similar rule applies where there is an allegation that a statute facially discriminates against interstate commerce, since a tax that unfairly apportions income from other states is a form of discrimination against interstate commerce. *Id.* This does not mean, however, that a tax that fairly apportions income does not discriminate against interstate or foreign commerce, nor that the fairly apportioned requirement and the no discrimination requirement are not separate, independent requirements.

same." Each is a separate requirement that a state tax must satisfy if it is to pass constitutional muster.

Thus, the issue in these matters is not the red herring which the Department suggests -- *i.e.*, is income fairly apportioned? Instead, the issue is whether the New Mexico taxing scheme, even with the Detroit Formula regulation, discriminates against foreign commerce. It is clear that it does.

Despite the Department's assertions to the contrary, fair apportionment cannot cure a facially discriminatory statute. As this Court has observed,

> Nothing about the apportionment process releases the State from the constitutional restraints that limit the way in which it exercises its taxing power over the income within its jurisdiction.
>
> . . . "Fairly apportioned" and "nondiscriminatory" are not synonymous terms.

Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 398-99 (1984).

In *Westinghouse*, New York employed a constitutionally acceptable apportionment formula (the standard three-factor formula). Nevertheless, in holding the state's constitutionally acceptable apportionment scheme could not shield a discriminatory levy from constitutional attack, this Court declared that the state's "fair apportionment" argument

> serves only to obscure the issue in this case. The acceptability of the allocation formula employed by the State of New York is not relevant to the question before us. The fact that New York is attempting to tax only a fairly apportioned percentage of a DISC's accumulated income does not insulate from constitutional challenge the State's method of allowing the DISC export credit.

Id. at 398.

The Department is similarly attempting to obscure the issue. New Mexico has constructed a facially discriminatory, constitutionally defective tax base, by including dividends from foreign commerce while excluding dividends from domestic commerce. The allegedly fair apportionment of this tax base cannot remove this defect in principle and does not remove it in practice.

The New Mexico Supreme Court was not misdirected by the Department's confused assertions. After analyzing the New Mexico tax scheme by applying settled principles of constitutional law, it concluded: "Accordingly, we hold that taxing of dividends from foreign subsidiaries under the separate corporate entity method is unconstitutional, even with the Detroit formula." (App. A, at App. 13, ¶16.)

3. The New Mexico Supreme Court's Decision Is Consistent with This Court's Jurisprudence Concerning Remedies

According to the Department, *McKesson Corporation v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990), which involved Florida's refusal to refund unconstitutional liquor excise taxes, only requires a state to remedy a discriminatory tax scheme by creating "a system which eliminates the discrimination as to the affected class as a whole." (Petition at 20.) The Department makes the incredible assertion that "[w]hether a particular taxpayer pays more or less than it would have paid under the former system is quite beside the point." (Petition at 20.)

The Department is wrong. Whether a particular taxpayer suffers impermissible discrimination is precisely the point. The Department's assertion is entirely inconsistent with this Court's decision in *McKesson*. Under *McKesson*, a state must

> provide a "clear and certain remedy" . . . to ensure that the tax as *actually imposed* on petitioner and its competitors during the contested tax period does not deprive petitioner of tax moneys in a manner that discriminates against interstate commerce.

McKesson, 496 U.S. at 43. This Court in *McKesson* prescribed a clear requirement:

> In order to cure the illegality of the tax as originally imposed, the State must ultimately collect a tax for the contested tax period *that in no respect* impermissibly discriminates against interstate commerce.

McKesson, 496 U.S. at 43, n.27 (emphasis added).

Therefore, to satisfy constitutional requirements, the Department's remedy must eliminate, not merely reduce, the offending discrimination by equalizing the treatment of Respondents' foreign-source and domestic-source dividends. Inasmuch as the Department's Detroit Formula regulation does not eliminate the discrimination suffered by Conoco and Intel, the Department's alleged "remedy" does not, as required by *McKesson*, result in a tax that "in no respect" impermissibly discriminates against foreign commerce.

The Department also incorrectly asserts that the decision of the New Mexico Supreme Court is "in direct conflict" with this Court's decisions in *Fulton Corp. v. Faulkner*, 116 S. Ct. 848 (1996) and *Harper v. Virginia Department of Taxation*, 509 U.S. 86 (1993). (Petition at 20.) The Department then makes the ominous statement that "one cannot assume that it will be ignored by other courts and legislatures as future problems arise." (Petition at 21.)

The Department, however, never explains how this "direct conflict" results. Moreover, the problem with the Department's alleged fears is that its premise is wrong. As previously discussed, the decision of the New Mexico Supreme Court is entirely consistent with this Court's decision in *McKesson*. The decision is also consistent with both *Fulton* and *Harper*.

Furthermore, the decision of the New Mexico Supreme Court adequately and appropriately addressed this issue. The New Mexico Supreme Court stated:

> When a tax is found unconstitutional, the Department may "either award full refunds to those burdened by an unlawful tax or issue some other order that 'create[s] in hindsight a nondiscriminatory scheme.'" *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 101, 113 S.Ct. 2510, 2519, 125 L.Ed.2d 74 (1993) (quoting *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 40, 110 S.Ct. 2238, 2252, 110 L.Ed.2d 17 (1990)). *See also Dart*, 657 A.2d at 1067 (requiring under Rhode Island law "a refund when a taxpayer has prepaid a tax and is subsequently successful in challenging the legality of that tax").

(App. A, at App. 19-20, ¶24.) The court then found that "[t]he Department apparently attempted to create a nondiscriminatory scheme with the retroactive application of the Detroit formula, *but this attempt was unsuccessful*." (App. A, at App. 20, ¶25 (emphasis added).)

4. The Department Confuses the Requisite Burden of Proof in Determining Whether Its Alleged Remedy Cures Its Otherwise Facially Discriminatory Tax Scheme

The Department's assertions questioning the burden of proof applied by the New Mexico Supreme Court demonstrate another area of confusion suffered by the Department. The Department is apparently asserting that for Respondents to be successful in their cases, they must demonstrate that the Department's alleged remedy (*i.e.*, its Detroit Formula regulation) is valid under no set of circumstances. (Petition at 18-20.)

The Department's assertion, however, confuses the burden of proof necessary to demonstrate that a statutory scheme is facially discriminatory -- a burden which has clearly been met in light of *Kraft* and the Department's public concessions -- and the burden of proof with respect to *remedies* necessary to cure a facially discriminatory tax scheme.

Nothing in this Court's decision in *McKesson Corporation v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990), even remotely suggests that a taxpayer bears the burden of proving that a proposed *remedy* is facially discriminatory (*i.e.*, that the remedy would be valid under "no set of circumstances"). To the contrary, *McKesson* requires that the remedy be one which "in no respect" discriminates against interstate (and foreign) commerce. *McKesson*, 496 U.S. at 43, n.27. Thus, the Department's assertions are without merit and further highlight its confusion.

As the New Mexico Supreme Court correctly held: "we find that the Taxpayers did not have the burden of proving that the New Mexico tax scheme, which discriminated against them individually, would discriminate against every conceivable taxpayer." (App. A, at App. 17-18, ¶22.)

5. The Department's Assertions Concerning Subpart F Income Attempts to Misdirect the Analysis Away from Its Unconstitutional Tax Scheme

The Department makes subtle assertions that Conoco's and Intel's use of the separate entity reporting method in conjunction with their receipt of Subpart F income from certain non-U.S. subsidiaries constitutes a purported "manipulation" of their income earned in New Mexico (Petition at 8-9). This is nothing more than an attempt by the Department to divert attention from the issue of discrimination, and may be readily disposed of. First, the Department has already stipulated that Subpart F foreign dividend income is to be afforded the same treatment as Respondents' other foreign dividend income. (*E.g.*, App. B, at App. 23 n.1.) Thus, the Department's assertions could be viewed as an artful attempt to gloss over the real issue.

Moreover, the Department does not explain adequately why its "manipulation" argument is in any way relevant to the actual issue of discrimination against dividends from foreign commerce. The Department has not heretofore objected to the exclusion of dividends from *domestic* commerce due to the

"manipulation" of earnings, even though the Department likely has similar concerns with respect to the income of U.S. subsidiaries that are not New Mexico taxpayers. Moreover, it should be noted that the Department has identified no actual "manipulation" by either Conoco or Intel. Indeed, the record contains ample evidence demonstrating that each company had various business reasons for operating through foreign subsidiaries.

Conoco's and Intel's decisions to operate foreign investments through non-U.S. subsidiaries and to use a separate entity filing method available to all taxpayers is not a "manipulation" of its earnings as suggested by the Department. Rather, it represents a valid business decision by each company that is predicated upon a filing method afforded to taxpayers by the New Mexico Legislature.

The Department's assertions concerning Subpart F income are therefore merely another attempt to direct the focus away from its unconstitutional tax scheme.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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